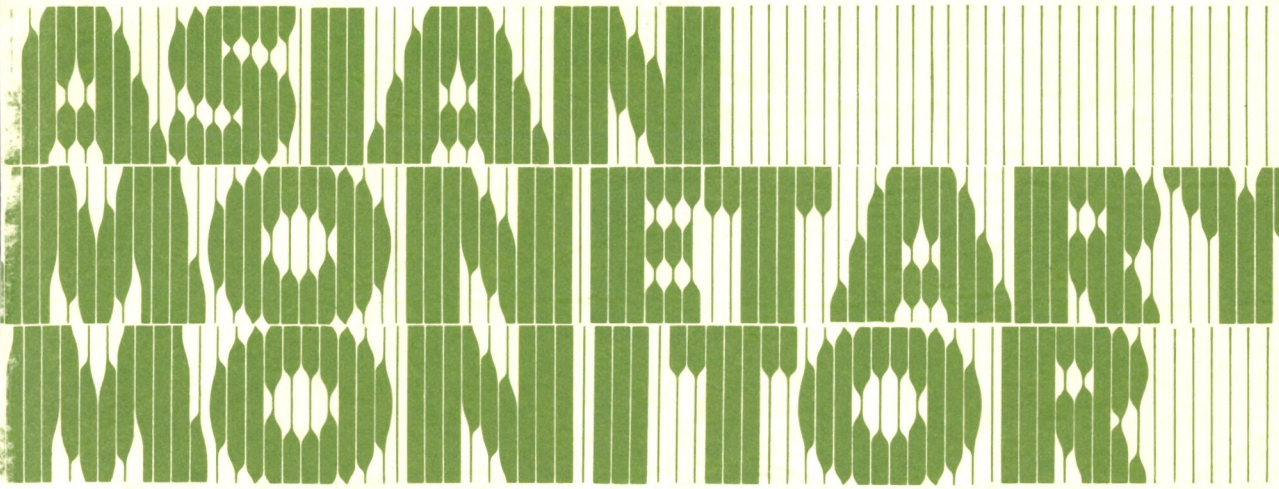




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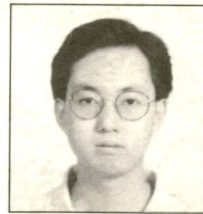
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REGIONAL SURVEY THE IMPACT OF CYCLICAL FACTORS AND COMPETITION ON BANK LOANS AND BANK MARGINS

Introduction

The banking systems in the region are currently undergoing rapid changes in terms of an acceleration in the process of deregulation, and increasing international competition. Irrespective, however, of the stage of deregulation and reform, purely cyclical factors such as fluctuations in the rate of growth of GDP affect the business of banks.

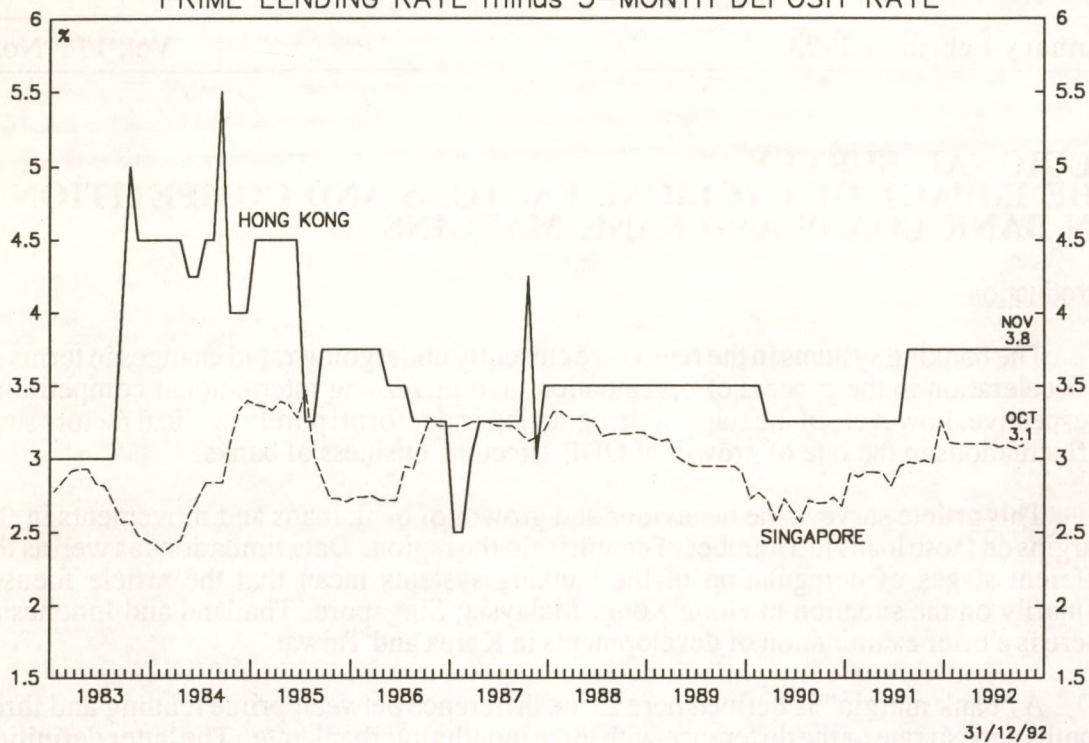
This article surveys the behaviour and growth of bank loans and movements in the margins on these loans in a number of countries in the region. Data limitations as well as the different stages of deregulation of the banking systems mean that the article focuses primarily on the situation in Hong Kong, Malaysia, Singapore, Thailand and Indonesia. There is a brief examination of developments in Korea and Taiwan.

A "bank margin" is defined here as the difference between prime lending and three months deposit rate or the difference with three months interbank rate. The latter definition is considered as the "bottom line" margin as banks are unlikely to finance loans by recourse to the interbank market unless they have no other choice. There is the added consideration that only some banks, but not all banks simultaneously, can use the interbank market to borrow funds. The bank margin so defined is undoubtedly a crude measure of loan profitability because banks charge prime rates only to a few select clients and because three months deposits are not necessarily the most important segment of the deposit base of banks. Furthermore, the cost of deposits is only one of the costs of making loans leaving out labour, rent and other expenses.

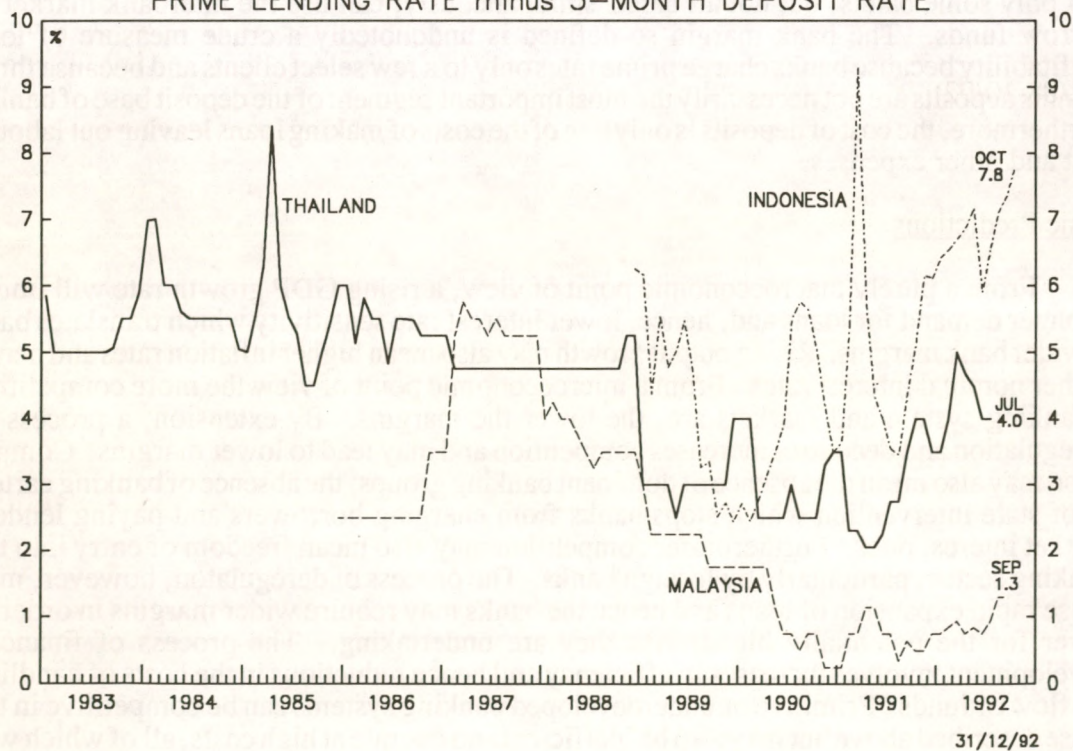
Basic Predictions

From a purely macroeconomic point of view, a rising GDP growth rate will imply stronger demand for loans and, hence, lower interest rate sensitivity which translates back to wider bank margins. Rising output growth may also mean higher inflation rates and hence higher nominal interest rates. From a microeconomic point of view the more competitive a banking system and markets are, the lower the margins. By extension, a process of deregulation and decontrol increases competition and may lead to lower margins. Competition may also mean the absence of dominant banking groups, the absence of banking cartels or of state intervention which stops banks from charging borrowers and paying lenders market interest rates. Furthermore, competition may also mean freedom of entry into the banking sector, particularly by foreign banks. The process of deregulation, however, may cause rapid expansion of loans and hence the banks may require wider margins in order to cover for the potentially higher risk they are undertaking. The process of financial development involves increases in efficiency and hence reductions in the costs of handling the flow of funds. Primitive or underdeveloped banking systems can be competitive in the sense described above but may also be inefficient and operate at high costs, all of which will be reflected in the margins charged.

REGIONAL SURVEY: CHART 1
PRIME LENDING RATE minus 3-MONTH DEPOSIT RATE



REGIONAL SURVEY: CHART 2
PRIME LENDING RATE minus 3-MONTH DEPOSIT RATE



Finally, the foreign exchange policy pursued may impact margins. A pegged exchange rate system can result in wider and more frequent interest rate fluctuations thus forcing banks to maintain higher margins. A freely floating exchange rate system, by comparison, could require fewer interest rate adjustments.

The Evidence

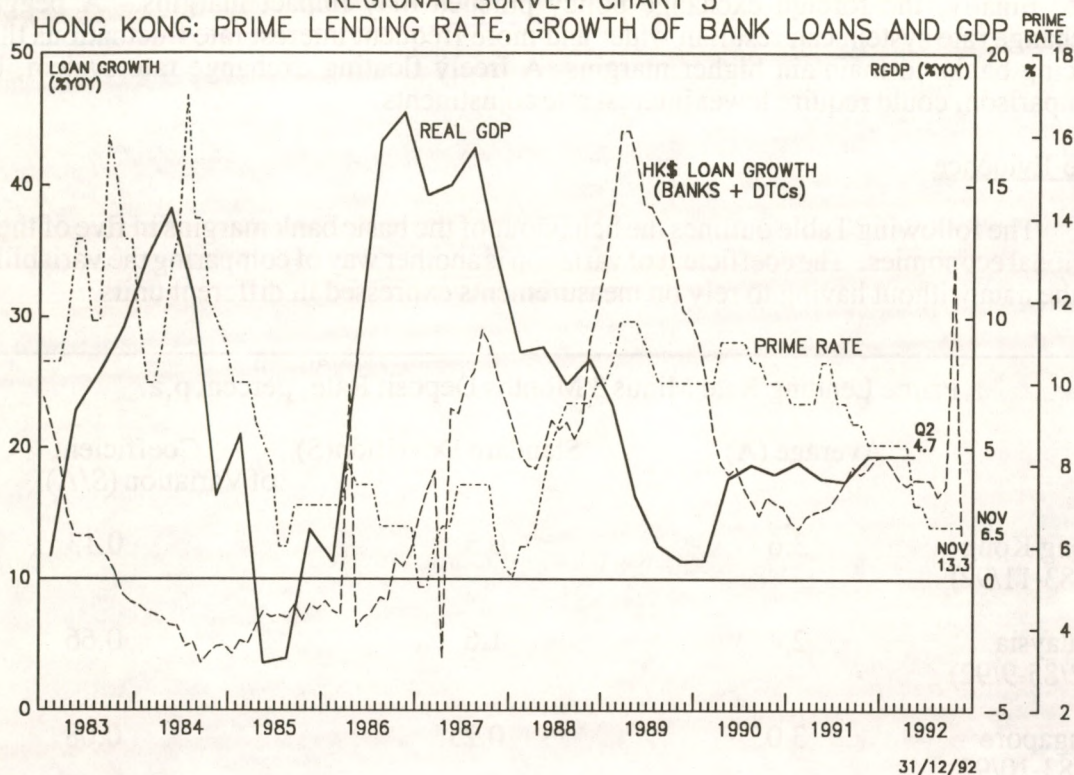
The following Table outlines the behaviour of the basic bank margins in five of these regional economies. The coefficient of variation is another way of comparing the variability of the data without having to rely on measurements expressed in different units.

Prime Lending Rate Minus 3 Months Deposit Rate, percent p.a.			
	Average (A)	Standard Deviation(S)	Coefficient of Variation (S/A)
Hong Kong (1/83-11/92)	3.6	0.5	0.13
Malaysia (12/85-9/92)	2.4	1.6	0.66
Singapore (1/83-10/92)	3.0	0.25	0.08
Thailand (1/83-7/92)	4.5	1.2	0.26
Indonesia (12/88-10/92)	5.0	1.6	0.32

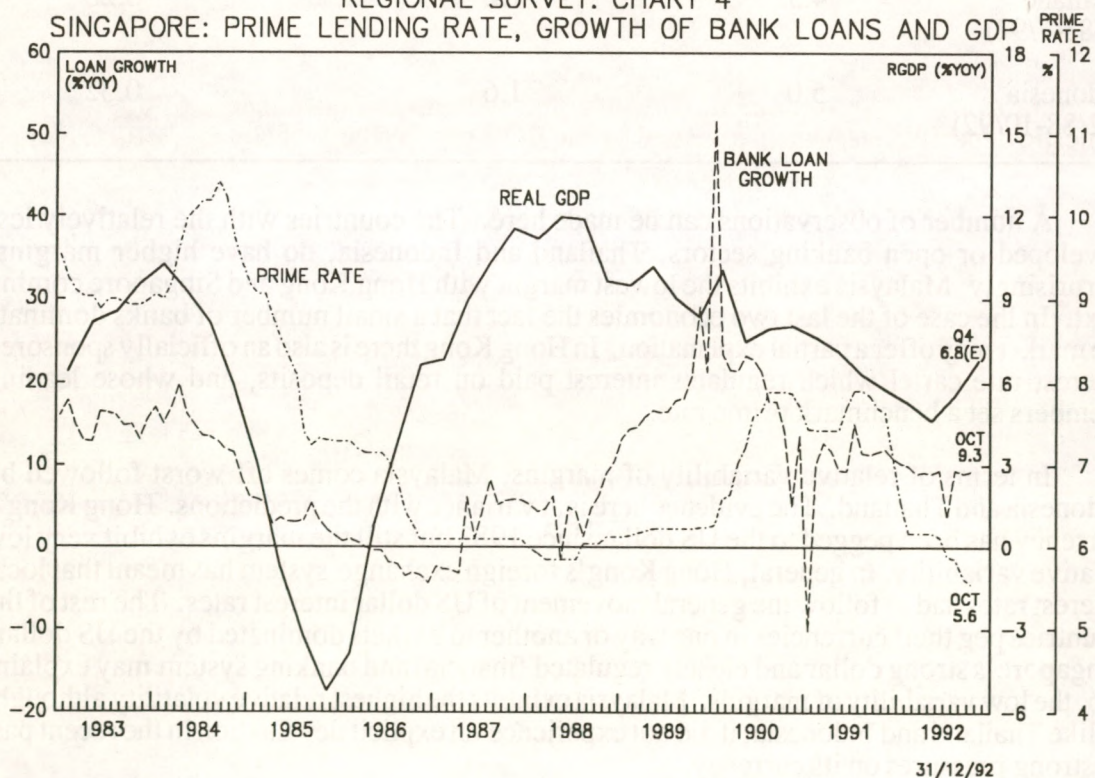
A number of observations can be made here. The countries with the relatively less developed or open banking sectors, Thailand and Indonesia, do have higher margins. Surprisingly, Malaysia exhibits the lowest margin with Hong Kong and Singapore coming next. In the case of the last two economies the fact that a small number of banks dominate the market may offer a partial explanation. In Hong Kong there is also an officially sponsored interest rate cartel which regulates interest paid on retail deposits, and whose leading members set a benchmark prime rate.

In terms of relative variability of margins, Malaysia comes off worst followed by Indonesia and Thailand. The evidence here is at variance with the predictions. Hong Kong's currency has been pegged to the US dollar since 1983 but still the margins exhibit very low relative variability. In general, Hong Kong's foreign exchange system has meant that local interest rates had to follow the general movement of US dollar interest rates. The rest of the countries peg their currencies in one way or another to baskets dominated by the US dollar. Singapore's strong dollar and closely regulated financial and banking system may explain, too, the low variability of margins. Malaysia exhibits the highest relative volatility although, unlike Thailand and Indonesia, it did not experience an explicit devaluation in the recent past or strong pressures on its currency.

REGIONAL SURVEY: CHART 3
HONG KONG: PRIME LENDING RATE, GROWTH OF BANK LOANS AND GDP



REGIONAL SURVEY: CHART 4
SINGAPORE: PRIME LENDING RATE, GROWTH OF BANK LOANS AND GDP



More detailed analysis, however, of the experience of individual countries casts a different light on these broad brushwork interpretations of the evidence.

Hong Kong

As Chart 1 indicates, since 1988 bank margins have been remarkably stable but on an overall rising trend. The sharp spikes in the margins reflected pressures on the Hong Kong dollar when prime rates adjusted sharply upwards. In Chart 3 the 1986-87 and 1992 spikes in loans growth reflected the temporary (and year-on-year) effect of public offers of shares which attracted a great deal of investor interest and, hence, bank loans. As Chart 3 indicates, growth of bank loans followed broadly the business cycle movement as shown by the year-on-year fluctuation of GDP. There are, however, some discrepancies. During 1983-84 the HK dollar crisis and the uncertainty over the Sino-British negotiations concerning the future of Hong Kong reduced loan growth. Property prices had peaked by the end of 1981 and experienced steep declines during 1982-83 troughing only towards the end of 1984. Hence the crash in the property market, particularly during 1982, also impacted subsequent loan growth. There is a further discrepancy between loans and GDP growth during 1989. As the "bulge" in the loan growth was not associated with a particularly high acceleration in money growth, it represented a temporary reallocation of banks' assets. (The figures in Chart 3 include loans from Deposit Taking Companies (DTCs), Hong Kong's quasi-banks. These institutions have now been renamed and reclassified as Restricted Licence Banks and DTCs. Their loans represent less than 13% of the total HK dollar loans extended by banks and, hence, are relatively unimportant.) The June 1989 Tiananmen Square incident accelerated the decline in the growth of loans.

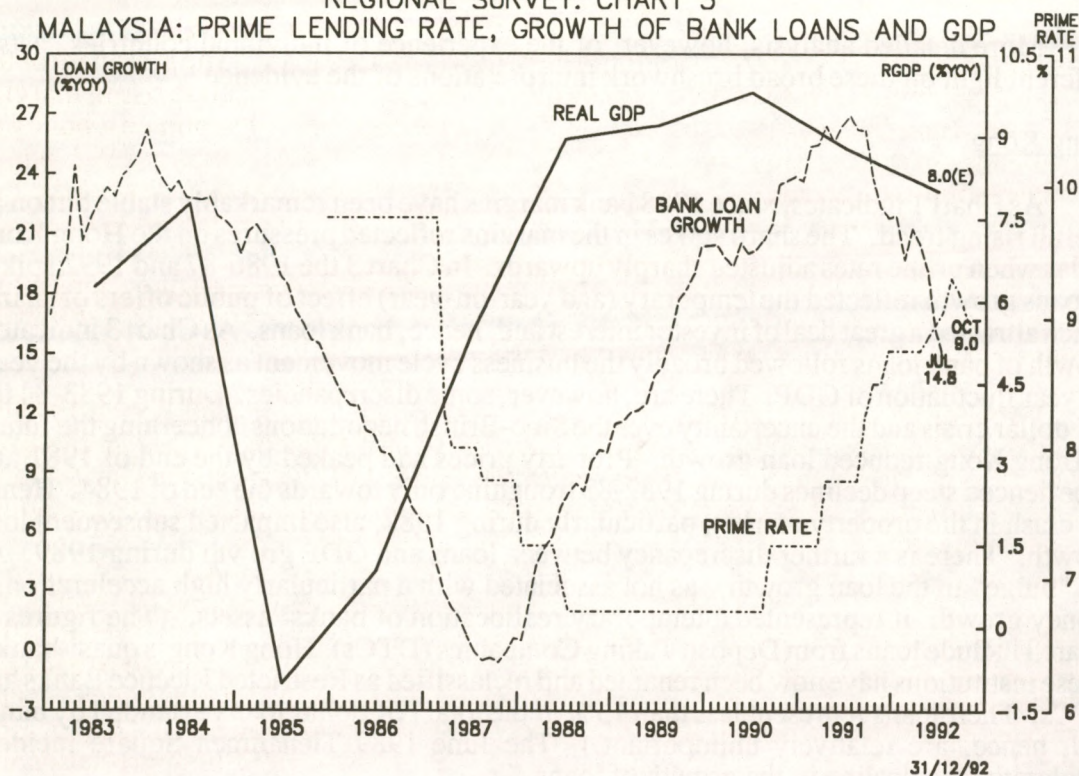
The overall regulatory environment in Hong Kong makes it one of the most open and liberal in the region. The existence, however, of an officially sponsored bank cartel helps to ensure high margins and will continue to do so whilst the cartel lasts. The dominance of the Hong Kong Bank group in the local market, with an estimated share of 60% of total domestic deposits, has been challenged by the BOC group (Bank of China), a PRC owned consortium. There is, as yet, no open competition on the basis of interest rates which could influence directly profit margins.

Singapore

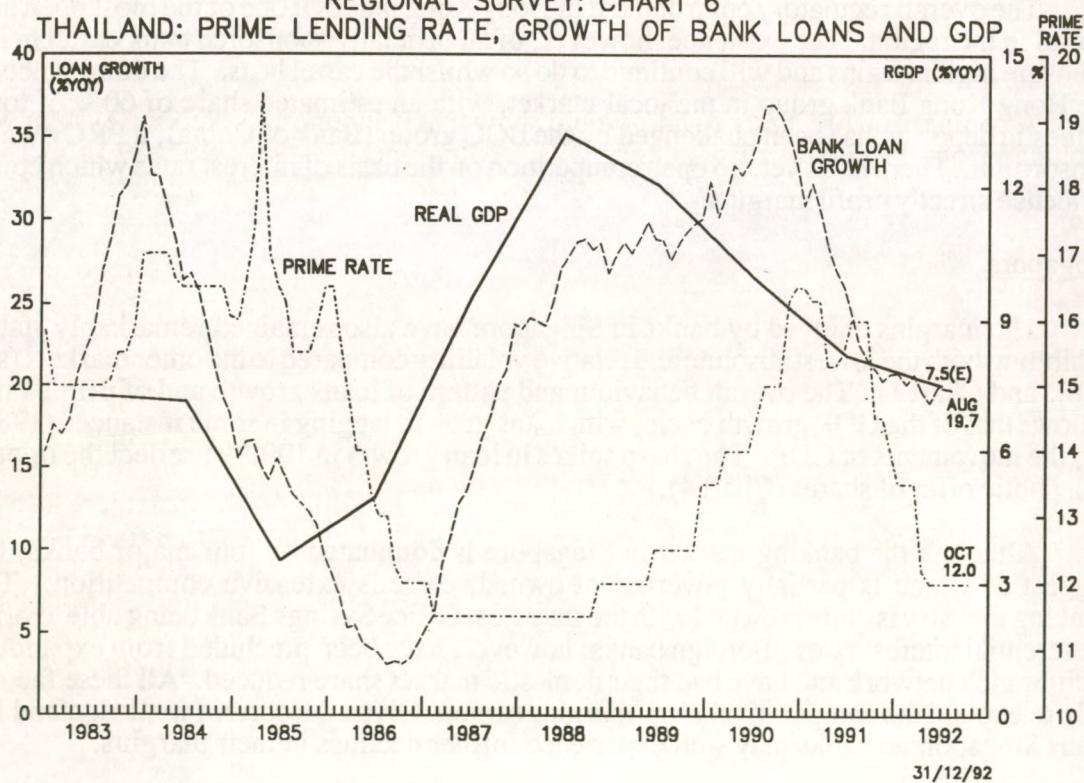
The margins enjoyed by banks in Singapore have also remained remarkably stable exhibiting both the lowest absolute and relative volatility compared to the other markets (see Table and Chart 1). The overall behaviour and pattern of loans growth and of prime rates follows that of the GDP growth cycle, with loans growth lagging in some instances (1987-89) the movements of GDP. The sharp spikes in loan growth in 1990-91 reflect the impact of a public offer of shares (Chart 4).

Although the banking market in Singapore is dominated by four major banks, the biggest of which is partially government-owned, there is extensive competition. The banking industry is quite crowded with the state Post Office Savings Bank being able to offer preferential interest rates. Foreign banks, however, have been precluded from expanding their branch network and have had their domestic market share reduced. All these factors help to explain the comparatively low margins earned. Given the current weak demand for loans Singaporean banks may well experience further declines in their margins.

REGIONAL SURVEY: CHART 5
MALAYSIA: PRIME LENDING RATE, GROWTH OF BANK LOANS AND GDP



REGIONAL SURVEY: CHART 6
THAILAND: PRIME LENDING RATE, GROWTH OF BANK LOANS AND GDP



Malaysia

The recession of 1985, when GDP contracted by 1%, also led to a severe banking crisis of a system heavily exposed to imprudent property-related loans. The aftermath of the crash and the rapid recovery of the economy did not lead to a commensurate rise in margins (see Charts 2 and 5). Indeed the central bank, Bank Negara, started to pursue a policy of deregulation and decontrol culminating with new regulations in February 1991 which decoupled the Best Lending Rate (BLR) of all the commercial banks from that of the two leading banks, Malayan Banking and Bank Bumiputra.

The banking sector in Malaysia is already quite competitive with concentration having declined over the last twenty five years or so. Foreign banks are very important players accounting for about 25% of loans and deposits in the domestic banking market.

Growing competition and the excess liquidity in the banking systems during 1991-92 have resulted during these two years in the lowest margins amongst the five countries surveyed here. The sharp increases in the prime rates since 1991 were reflected in increases in margins. Loan growth did not peak until 1991 Q1 but then continued quite strong although on a declining trend.

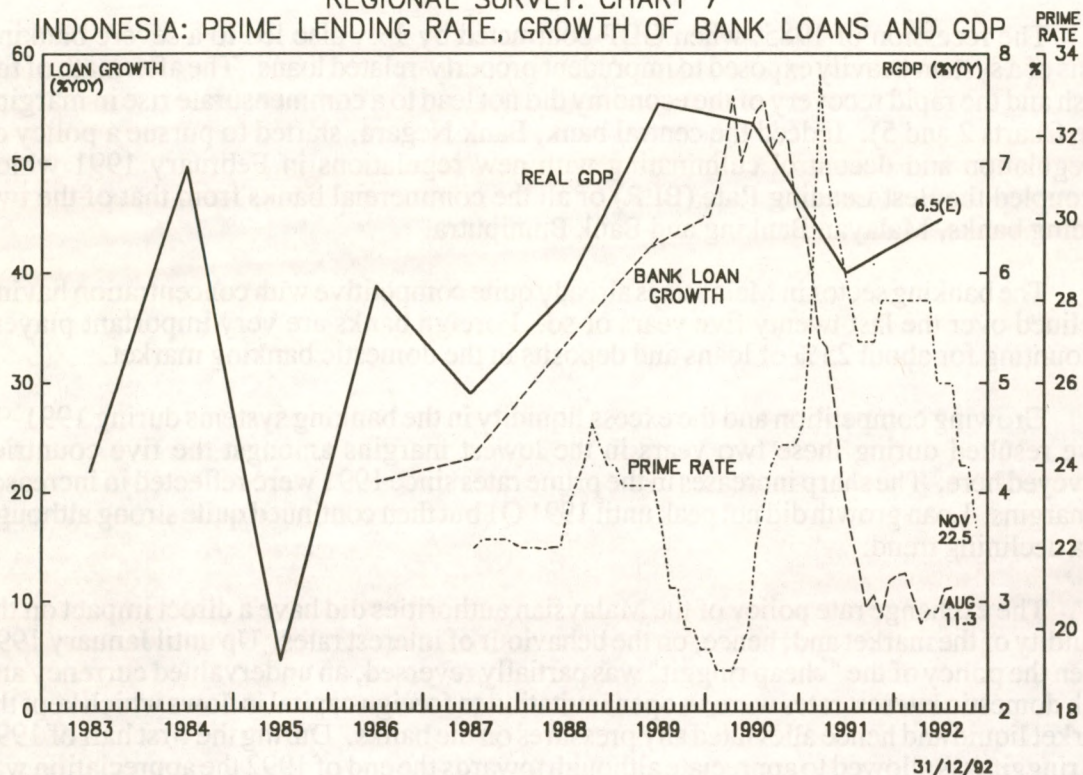
The exchange rate policy of the Malaysian authorities did have a direct impact on the liquidity of the market and, hence, on the behaviour of interest rates. Up until January 1992 when the policy of the "cheap ringgit" was partially reversed, an undervalued currency and high domestic interest rates were an open invitation to foreign capital inflows which kept the market liquid and hence alleviated any pressures on the banks. During the first half of 1992 the ringgit was allowed to appreciate although towards the end of 1992 the appreciation was capped and partially reversed. Margins, however, continued to rise during 1992 although it has to be stressed that in comparative and in historic terms these margins are still quite low.

Thailand

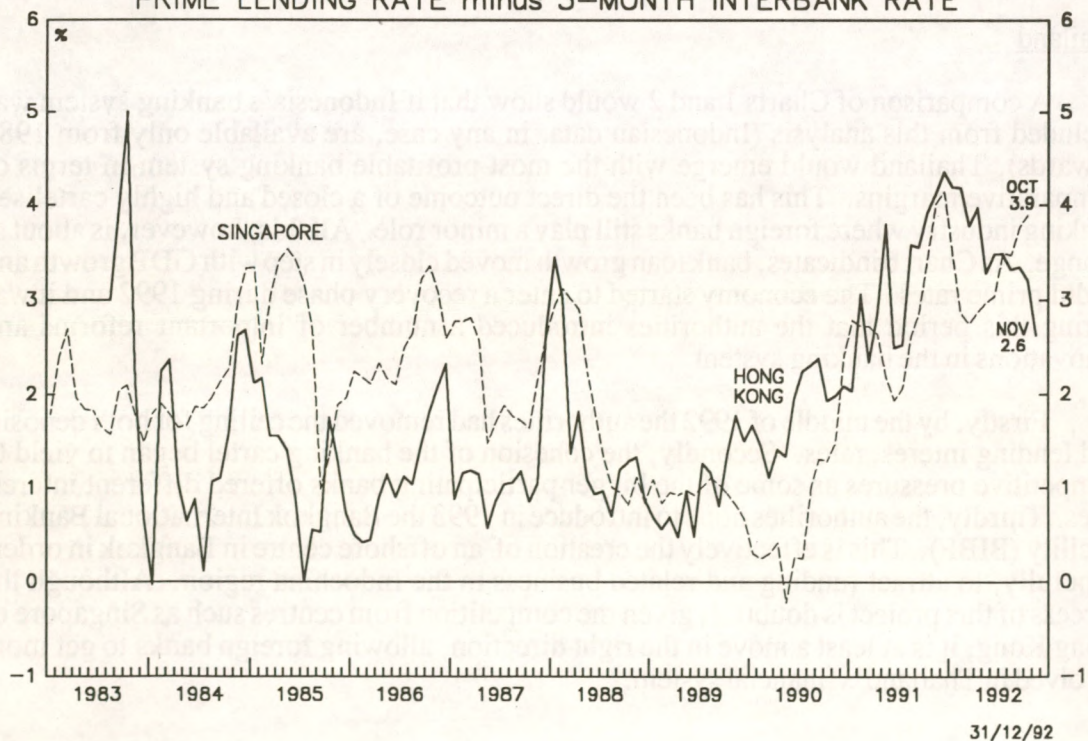
A comparison of Charts 1 and 2 would show that if Indonesia's banking system was excluded from this analysis (Indonesian data, in any case, are available only from 1989 onwards), Thailand would emerge with the most profitable banking system in terms of comparative margins. This has been the direct outcome of a closed and highly cartelised banking industry where foreign banks still play a minor role. All this, however, is about to change. As Chart 6 indicates, bank loan growth moved closely in step with GDP growth and so did prime rates. The economy started to enter a recovery phase during 1992 and it was during this period that the authorities introduced a number of important reforms and innovations in the banking system.

Firstly, by the middle of 1992 the authorities had removed the ceiling for both deposits and lending interest rates. Secondly, the cohesion of the banking cartel began to yield to competitive pressures as some of the bigger participating banks offered different interest rates. Thirdly, the authorities hope to introduce in 1993 the Bangkok International Banking Facility (BIBF). This is effectively the creation of an offshore centre in Bangkok in order, hopefully, to attract funding and related business in the Indochina region. Although the success of this project is doubtful, given the competition from centres such as Singapore or Hong Kong, it is at least a move in the right direction, allowing foreign banks to get more involved in Thailand's financial system.

REGIONAL SURVEY: CHART 7
INDONESIA: PRIME LENDING RATE, GROWTH OF BANK LOANS AND GDP



REGIONAL SURVEY: CHART 8
PRIME LENDING RATE minus 3-MONTH INTERBANK RATE



The offshore funding activities of Thai banks have, in the past, given rise to concern to the authorities, particularly during periods of increasing domestic interest rates. Banks borrowed offshore and lent the money at home at much higher interest rates and with relatively little exchange rate risk since the Baht is effectively pegged to the US dollar. The mechanics and consequences of offshore borrowing by banks in order to finance domestic credit expansion are quite complex and are examined separately in an Appendix to this article. The ability of domestic banks to bypass regulations or credit constraints at home by borrowing overseas and the impact of these activities on money stock growth are ultimately dependent on the foreign exchange rate policy pursued by the central bank in question.

Indonesia

The banking system of Indonesia was transformed by the reforms introduced in October 1988. Local and foreign banks were permitted to open branches, minimum reserve requirements were drastically reduced, and all banks were allowed to seek out actively new deposits and offer new products. Inevitably there was an explosion of lending activity reflected also in sharp increases in the rate of growth of money stock. Retrenchment followed with the so-called "Sumarlin shock" of February 1991 when liquidity restrictions were imposed. The central bank, Bank Indonesia, had started to push up interest rates from the summer of 1990 as inflation accelerated. Monetary policy since then has remained tight.

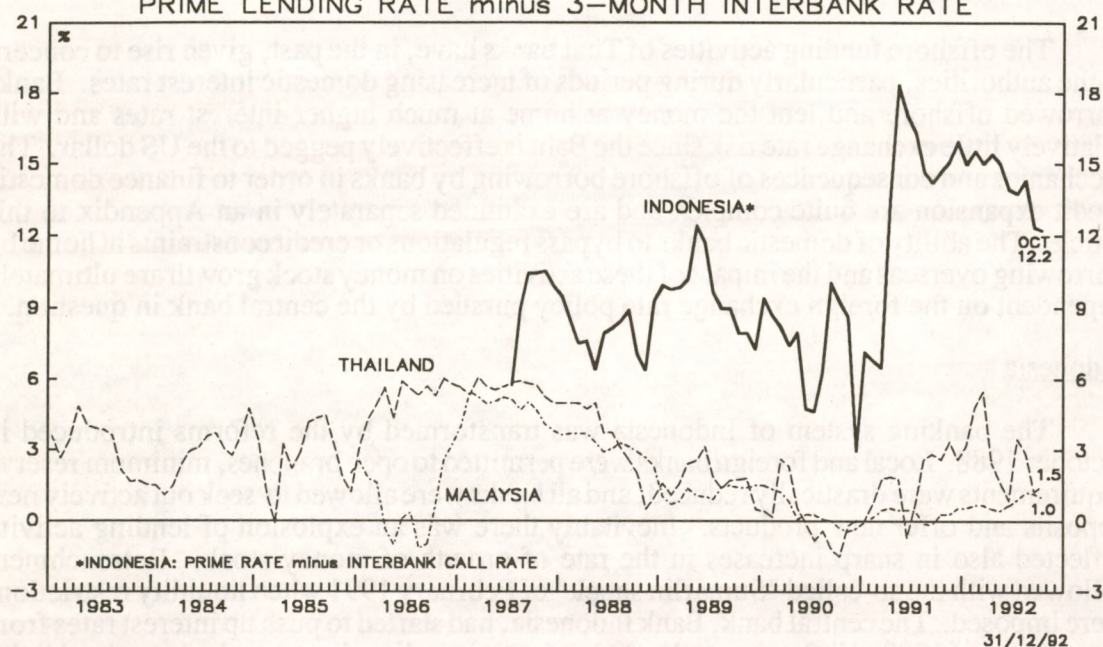
Given the underdevelopment of the Indonesian credit market and the relatively short span during which the banks were allowed to operate unfettered and unrestricted (October 1988 to February 1991) before monetary restrictions were imposed, it is not surprising that Indonesian margins are the highest amongst the markets surveyed (Chart 2). These margins reflect both the risk of lending to a new market and the earlier stages of competition when borrowers and lenders are exploring and learning the dynamics of the market. The sharp spike in the margin in February 1991 was, of course, the outcome of the shock.

Chart 7 illustrates the close correlation between the growth rates of GDP and bank loans in Indonesia. The increases in prime rate from April 1990 onwards helped to bring down demand for loans.

The headlong expansion of bank loans during 1988-89 has now left a legacy of failed banks and of poor quality balance sheets. During the next stage, however, in Indonesia's financial cycle the banking sector may be better prepared and more conservative in its policies. Indonesia, however, has now laid the foundations of a dynamic and competitive banking system, and this will be reflected, eventually, in lower margins.

As indicated at the introduction of this article, the difference between prime and interbank rates can be considered as the "bottom line" margin for making loans. Charts 8 and 9 confirm some of the broad trends shown in Charts 1 and 2. Indonesia and Thailand exhibit the widest margins whilst Malaysia, in general, still has the lowest ones even compared to those of Hong Kong and Singapore.

REGIONAL SURVEY: CHART 9
PRIME LENDING RATE minus 3-MONTH INTERBANK RATE



Korea and Taiwan

Korea's banking system has long been dominated by direct government controls and intervention. The authorities have in the past issued instructions to banks as to preferential loan allocation and interest charges and have only partially moved towards deregulation of interest rates. There is a plan which proposes to lift all restrictions on lending rates and on some deposit rates during 1993. If this was to happen, and Korea has a rather long history of delaying and postponing interest rate deregulation, then bank margins could be squeezed. The economy is expected to enter a recovery phase, but during the first half of 1993 demand for loans could be relatively weak.

In Taiwan the authorities took a number of significant policy measures to deregulate the banking market. During 1992 fifteen new banks were allowed to enter the market, the state will privatise a number of government controlled banks and the range of activities and services which can be offered by banks has widened considerably.

SUMMARY AND CONCLUSIONS: Not surprisingly, given the cyclical considerations, measures which promote competition tend to reduce bank margins. The two mature markets, Hong Kong and Singapore are by no means the most competitive ones, with Hong Kong still controlling interest rate competition via an officially sponsored cartel. The situation in both these markets is unlikely to change drastically in the near future. The other comparative extreme is Indonesia where unfettered competition did not result in lower margins but, eventually, in a bank crisis. Once the consequences of this crisis have been cleared, bank margins in Indonesia can be expected to stabilise and then to fall. Similarly, Thailand will experience the consequences of competition but since the process of deregulation has been much slower, the impact on margins will be gradual. There are at present no major institutional changes taking place in Malaysia whilst the Taiwanese banking system is being gradually reformed and the Korean still awaits significant changes.

APPENDIX

Banks and Offshore Borrowing

There is a great deal of misunderstanding concerning the mechanism and the consequences of banks borrowing offshore in order to finance domestic credit expansion. The basic argument is that if a bank cannot obtain deposits from the non-banking public or cannot borrow from other local banks in order to lend, then it can borrow overseas, "repatriate" the funds so obtained and then lend them in the local market.

As will be shown presently only some of the banks within the local system can do this but not all the banks simultaneously, unless there are some exceptional foreign exchange rate policies in place. Since the banking system as a whole can only obtain deposits by lending, not the other way around, the stock of deposits or money cannot grow through "importing" money. However, for some of the banks, but not all banks, it is possible to obtain deposits and thus acquire capacity to lend. (For a detailed discussion of this issue see AMM Vol. 14 No. 5, September-October 1990.) *Ceteris paribus* heightened competition for deposits -- a so-called "deposit war" -- implies lower margins.

The tree chart illustrates all the possible outcomes of a bank borrowing overseas. Despite their seeming complexity these outcomes are basically simple. Outcomes (1), (5) and (8) are identical as are (4) and (7) and equally (3) and (6), thus reducing the variations from nine to four, namely (1), (2), (3) and (4) or (7) which are identical.

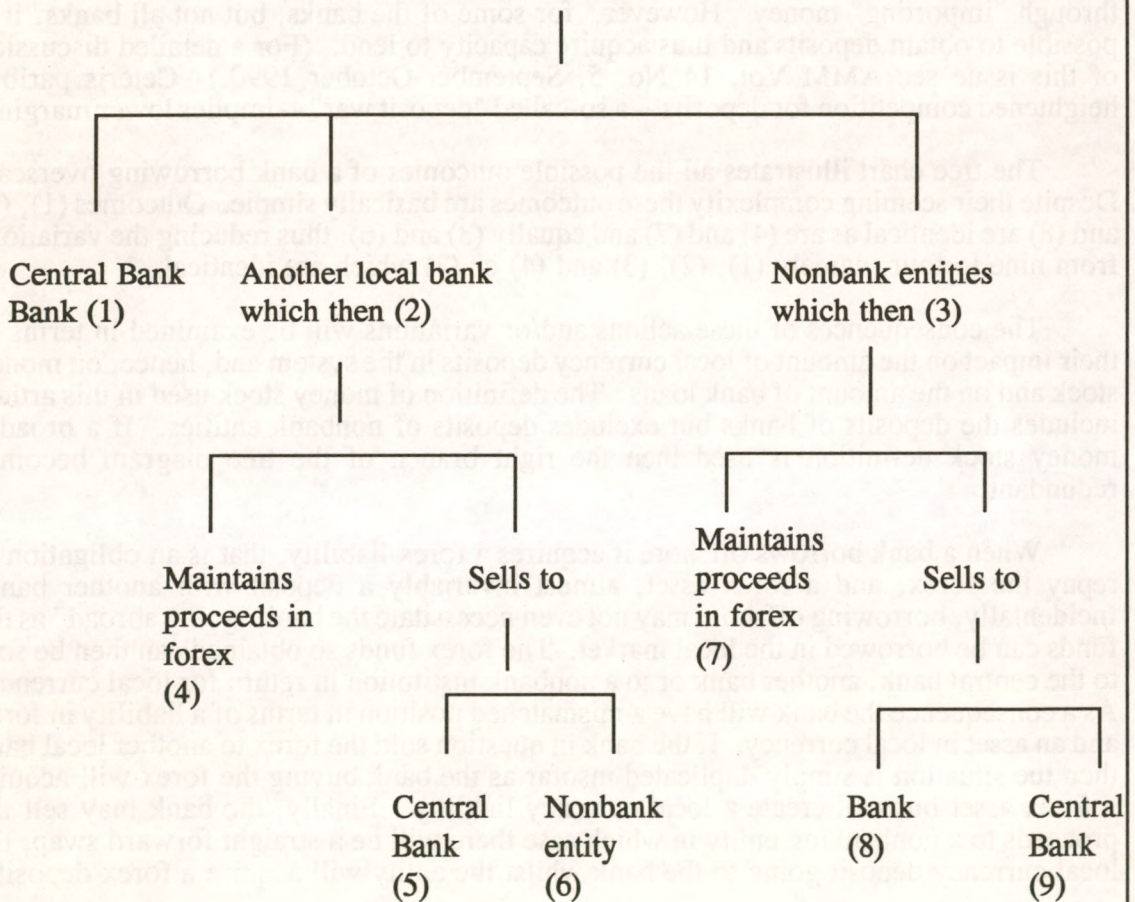
The consequences of these actions and/or variations will be examined in terms of their impact on the amount of local currency deposits in the system and, hence, on money stock and on the amount of bank loans. The definition of money stock used in this article includes the deposits of banks but excludes deposits of nonbank entities. If a broader money stock definition is used then the right branch of the tree diagram becomes redundant.

When a bank borrows offshore it acquires a forex liability, that is an obligation to repay the forex, and a forex asset, almost invariably a deposit with another bank. Incidentally, borrowing offshore may not even necessitate the bank "going abroad" as the funds can be borrowed in the local market. The forex funds so obtained can then be sold to the central bank, another bank or to a nonbank institution in return for local currency. As a consequence the bank will have a mismatched position in terms of a liability in forex and an asset in local currency. If the bank in question sold the forex to another local bank then the situation is simply duplicated insofar as the bank buying the forex will acquire a forex asset but will create a local currency liability. Finally, the bank may sell the proceeds to a nonbanking entity in which case there will be a straight forward swap, the local currency deposit going to the bank whilst the entity will acquire a forex deposit.

In case (1) in the tree chart, the money base in the economy has increased but not the money stock. The bank can now switch some or all the local currency obtained into a loan. In this case it simply reshuffles the assets from a forex deposit into a local currency denominated loan. Now the recipient of the loan may proceed to spend it, implying that the funds are redeposited with another bank. It is at this stage that both the sum total of loans and money stock rise. Of course, when the bank needs to repay the forex loan, the whole process is reversed. Assuming that forex is obtained again from the central bank by selling local currency then the monetary base will decrease as will the sum total of loans and money stock.

Tree Chart

Bank borrows overseas and sell forex proceeds to



In case (2), the bank which buys forex from the original bank provides the local currency in the form of an interbank deposit. Now the original bank still has a mismatch of forex liabilities but local currency assets. The bank which provided the local currency has switched one asset into another (local into forex) and may now have a mismatch depending on its original situation. The original bank can proceed to switch the deposit in local currency into a loan, thus increasing the sum total of loans in the economy. As the bank which provided the local currency has actually created a deposit in the process of doing so, money stock has now increased.

At this juncture a caveat must be entered because the situation as it stands is effectively unattainable except in the very short run. It is unlikely that both banks will be willing, or even be permitted, to maintain uncovered positions in forex. Furthermore, the bank which provided the local currency will automatically have a liquidity constraint as it will have to maintain reserves against the newly created local currency deposit. If both banks cover their positions, i.e. buy forex forward or equivalently sell local currency forward, then the transactions will be reversed and the impact on total bank loans outstanding and money stock will be temporary.

Case (5) in the tree chart is identical to (1). This now leaves option (3) which, in a way is, the most straightforward. If a nonbank entity provides the local currency then all that happens is a swap of assets. The original bank acquires a local currency deposit which is then lent. There is an addition to the sum total of loans as the original bank swaps a forex asset for a local loan. Given however that the sum total of deposits does not change, there is no change in the stock of money.

It now follows that case (8) corresponds to (2) and case (9) corresponds to (5) and (1).

Cases (4) and (7) are of no interest because the impact of the original transaction on loans and money stock still remains.

In sum, only if the forex borrowed is sold to the central bank will the monetary base increase and hence money stock may expand by a multiple. Money stock will also increase in the case where the transactions are undertaken amongst the banks themselves, as will the sum total of loans. If the transactions are undertaken with a nonbanking entity there is no impact on money stock but the amount of loans will increase. As all these flows originate from a forex loan which will need to be repaid, hence they are all temporary, although, obviously the period of this duration will depend on the period of the loan.

Thus the impact of these activities on monetary policy and the question of whether the banks can "bypass" monetary controls by borrowing overseas will be dependent on a number of factors.

Firstly, if the central bank is pursuing a policy of pegged exchange rates then the banks will be able to obtain local currency at a relatively risk-free exchange rate. The impact will be directly on the monetary base and hence on the money stock, assuming no change in the money multiplier.

Secondly, if exchange rates are freely fluctuating the cost of forward cover will decrease the expected returns on the loans or, equivalently, will make the cost in terms of local currency higher. In any case, the impact will be temporary as the forex loan will be repaid.

Thirdly, monetary authorities may impose limits on uncovered positions or additional reserve requirements on domestic loans financed through foreign borrowings.

Fourthly, the overall impact of interbank transactions on money stock will be dependent on the amounts of excess reserves available to banks. As indicated banks buying the forex obtained from the loans will create a local currency deposit for which they will have to maintain the appropriate reserves.

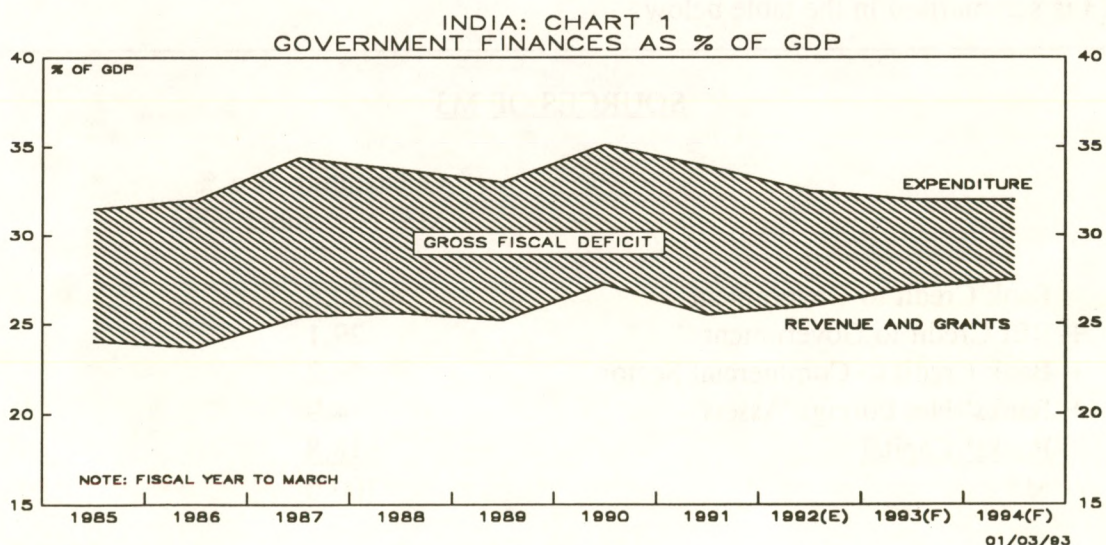
Finally, and most importantly, individual banks or groups of banks only, but not all the banks in the system, can use foreign loans to expand their domestic borrowing. This is so because not all banks simultaneously can be buyers of forex and sellers of local currency. The only exception is if the central bank accommodates this move, but that implies a pegged exchange rate policy and total absence of control over the monetary base. Equally, if all banks are net buyers or sellers of forex but the central bank does not accommodate this transaction then the banks can only deal with the nonbank private sector. The consequence of this has already been explored.

To repeat, the only way that foreign loans can be used to expand domestic loans and money stock permanently is if a country runs a continuous overall surplus in its balance of payments and the central bank provides at a fixed rate local currency against forex, i.e. runs a pegged exchange rate policy. The Malaysian and Thai authorities have at different times imposed forward limits or even taxes on interest in order to discourage local banks from arbitraging the higher local rates by borrowing offshore. Otherwise there are no examples of banks evading consistently monetary policy restrictions through foreign borrowings.

INDIA REFORM BACK ON TRACK BUT ECONOMIC DISTORTIONS REMAIN

Until the announcement of the 1993-94 (to March) budget, ethnic unrest and stockmarket scandals had diverted attention away from Narasimha Rao's valiant attempt to reform India's closeted economy. After assuming power in July 1991, Rao cut taxes and tariffs, abolished import licenses, eased considerably restrictions on foreign investment and made the Rupee partially convertible. However, these mainly microeconomic reforms were relatively easy to implement; difficult decisions concerning financial sector liberalisation, privatisation and the labour market were avoided and thus inefficiencies in these areas were highlighted by the limited reforms elsewhere. While the seriousness of the Ayodhya-inspired rioting cannot be underestimated -- the same issue helped topple the V.P. Singh government in 1990 -- the country has experienced a number of cycles of communal unrest since independence but has always survived intact. The real danger had seemed to be to the reform process which appeared to have become sidelined. Liberalisation had been driven by two or three key individuals while parliament and the bureaucracy had given tacit support. However, such support could have easily been withdrawn if it had been judged to be politically expedient. This danger still remains given the opportunistic nature of Indian politics, and thus Rao must demonstrate strong leadership over the next few months to diffuse the Ayodhya issue and retain his parliamentary majority. Nevertheless, the decisive budget delivered by finance minister Dr. Manmohan Singh should help to restore both domestic and foreign investor confidence, and should lay the platform for the next and more difficult stage of reforms.

The budget for fiscal 1993-94 announced at the end of February, clearly signalled the government's resolve. Announcements included the full convertibility of the Rupee on current account transactions, a cut in interest rates, further lowering of tariffs, import duties and various taxes, and boosts to much needed development expenditure. However, positive though the budget was, major and contentious areas of reform have still to be addressed to reduce permanently the government's large budget deficit, to reform the country's archaic financial system, and to stimulate the moribund economy without reigniting inflation.



The budget deficit (Chart 1) remains the root of most of the economy's ills. It diverts scarce financial resources from the private sector, it supports inefficient and loss-making enterprises that would otherwise rationalise or fail, and it maintains a stifling, overstaffed bureaucracy. The most commonly quoted measure, the gross fiscal deficit which records the excess of total government expenditure over revenue receipts and grants, has been brought down from 8.4% of GDP in fiscal 1990-91 to 6.5% in 1991-92. For 1992-93 it is expected to have shrunk further to 5% of GDP and the government has forecast another fall to 4.5% of GDP during 1993-94. However, these gains have mainly been achieved by squeezing much needed development expenditure such that its share in GDP has fallen by almost 3%, to below 20%, in the last two years. True, some gains have been made in cutting subsidies (although many have been merely reclassified or restructured) and more recently, in increasing the direct tax yield (up 80% in 1992-93 but from a very low base). Nonetheless, defence spending and bureaucratic costs have been little touched, while interest payments on accumulated debt continue to rise and now absorb around a quarter of total expenditure. Moreover, so far the implementation of the privatisation programme has been rather limited.

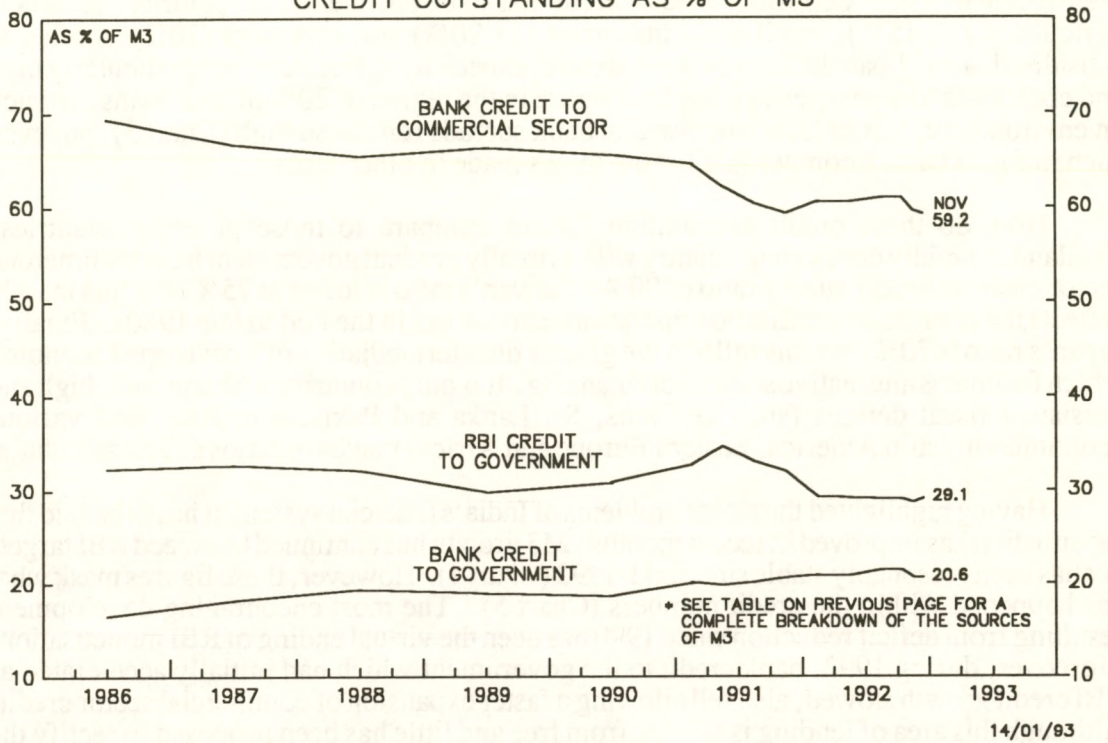
Aside from the direct drain on the economy's resources, deficit financing results in major distortions in an archaic financial system. One way of looking at this problem is to examine the distribution of credit outstanding as a percentage of broad money (in this case M3). The Indian government cannot rely on foreign capital to fund its deficit so for the most part it has to fund internally. As a result, banks are subject to a statutory liquidity ratio (SLR) of 37.75% which requires them to buy government bonds at below market interest rates. (The SLR includes a cash reserve ratio of 15% of demand and time liabilities (10% on incremental deposits since May 1991) and the remainder is to be held in central and local government paper. Since April 1992, the SLR on incremental deposits has been 30%.) The high SLR is reflected in bank credit outstanding to the government which stands at over 20% of M3. However, this is still insufficient to fund the persistently large deficit and as a result central or Reserve Bank (RBI) credit to the government is a worrying and inflationary 29.1% of M3. (The RBI does not hold government paper for the purpose of conducting open market operations, but rather it buys bonds at issue and holds them until maturity. In effect, it therefore monetises government debt.) This leaves only 59.2% of M3 available for commercial sector credit. Chart 2 shows the distribution of credit outstanding as a percentage of M3. The complete composition of the counterparties to M3 is summarised in the table below.

SOURCES OF M3

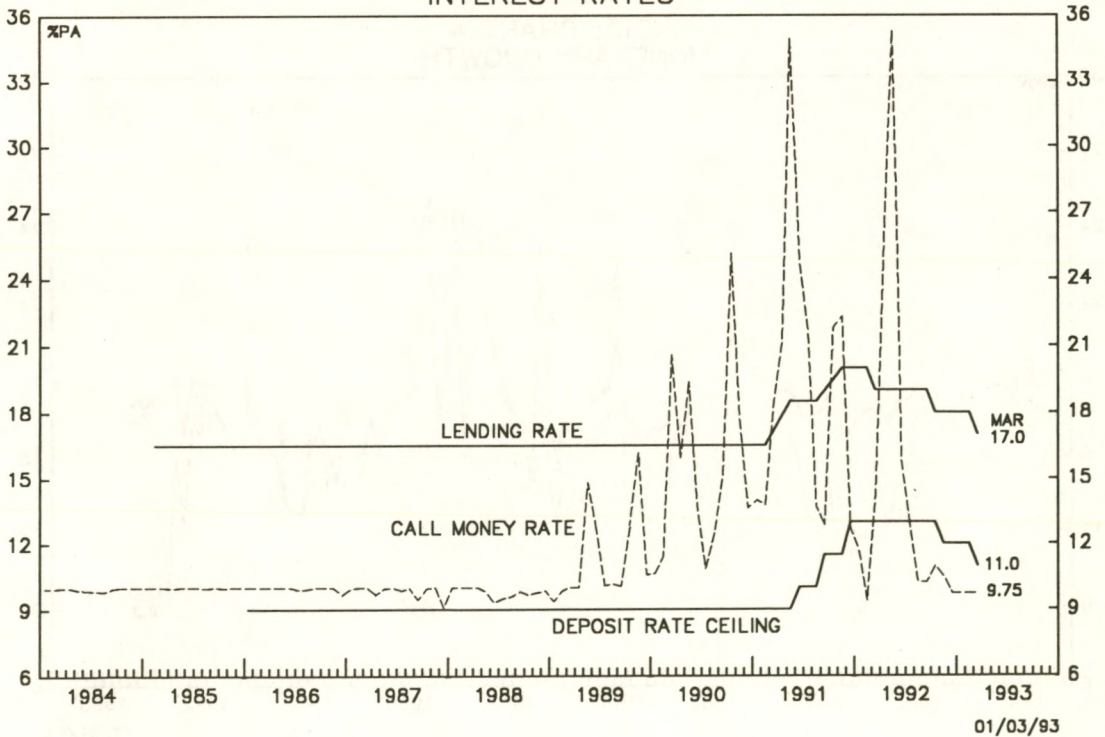
Outstanding as a %
M3, November 1993

Bank Credit to Government	20.6
+ RBI Credit to Government	29.1
+ Bank Credit to Commercial Sector	59.2
+ Banks' Net Foreign Assets	4.9
- <u>Banks' Capital</u>	<u>13.8</u>
M3	100.0

INDIA: CHART 2
CREDIT OUTSTANDING AS % OF M3



INDIA: CHART 3
INTEREST RATES

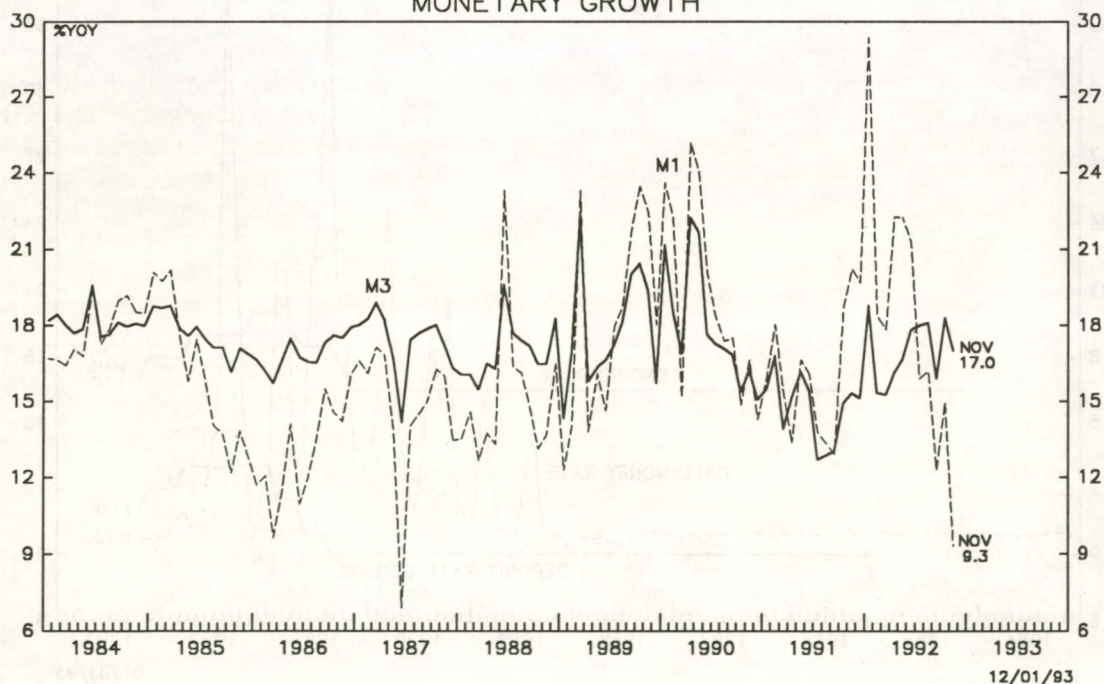


Unfortunately, the story does not stop here. Banks are still far from free to lend against their residual "Free" deposits. 40% of credit has to be channelled to "priority" sectors -- agriculture (10-15%), small-scale industries (15-20%) and exporters (10%) -- often at subsidised rates. Loan defaults by these sectors, especially agriculture, are particularly high and contribute to a non-performing loan figure in the region of 20% of total loans. In such an environment, it is of little surprise that bank spreads remain so high (Chart 3), but even such margins cannot compensate for the losses made in other areas.

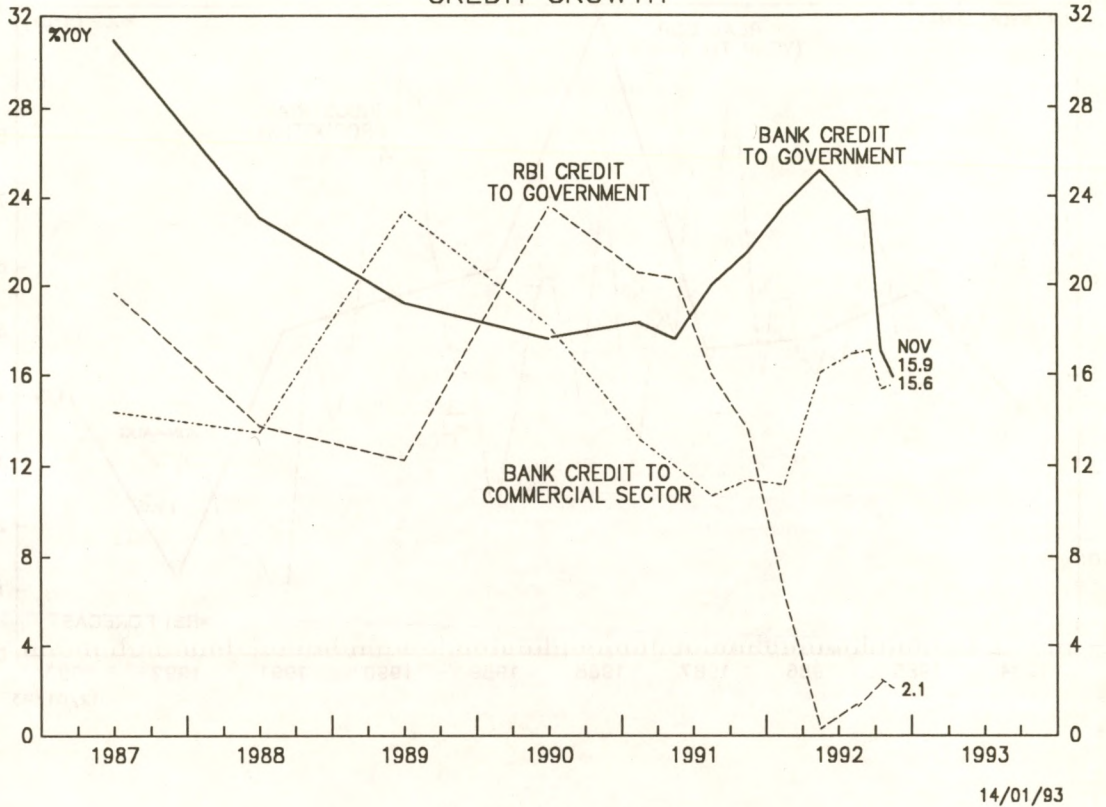
How do these credit distribution figures compare to those of other countries? Thailand, a rapidly developing country with a fiscally prudent government has a commercial sector credit to broad money ratio of 90%. Taiwan's ratio is lower at 75%, but this mainly reflects the enormous sterilisation operations carried out in the mid to late 1980s. Finally, Japan's ratio is 70%, but this reflects the greater disintermediation of a developed economy which facilitates alternative sources of financing. It is only countries with similarly high and persistent fiscal deficits (such as China, Sri Lanka and Pakistan in Asia, and various economies in Latin America, Eastern Europe and Africa) that have ratios as low as India's.

Having highlighted the major problems of India's financial system, it has to be said that the situation has improved in recent months. M3 growth has continued to exceed RBI targets but has been reasonably stable since mid-1992 (Chart 4). However, these figures mask what has happened within the credit numbers (Chart 5). The most encouraging development resulting from deficit reduction since 1990 has been the virtual ending of RBI monetisation. Moreover, during 1992, bank credit to the government which had initially accelerated as RBI credit growth slowed, also fell allowing a faster expansion of commercial sector credit. Although this area of lending is still far from free and little has been proposed to rectify the situation, the trend is positive in that it adds (at the margin) to the private sector's share of the pie.

INDIA: CHART 4
MONETARY GROWTH

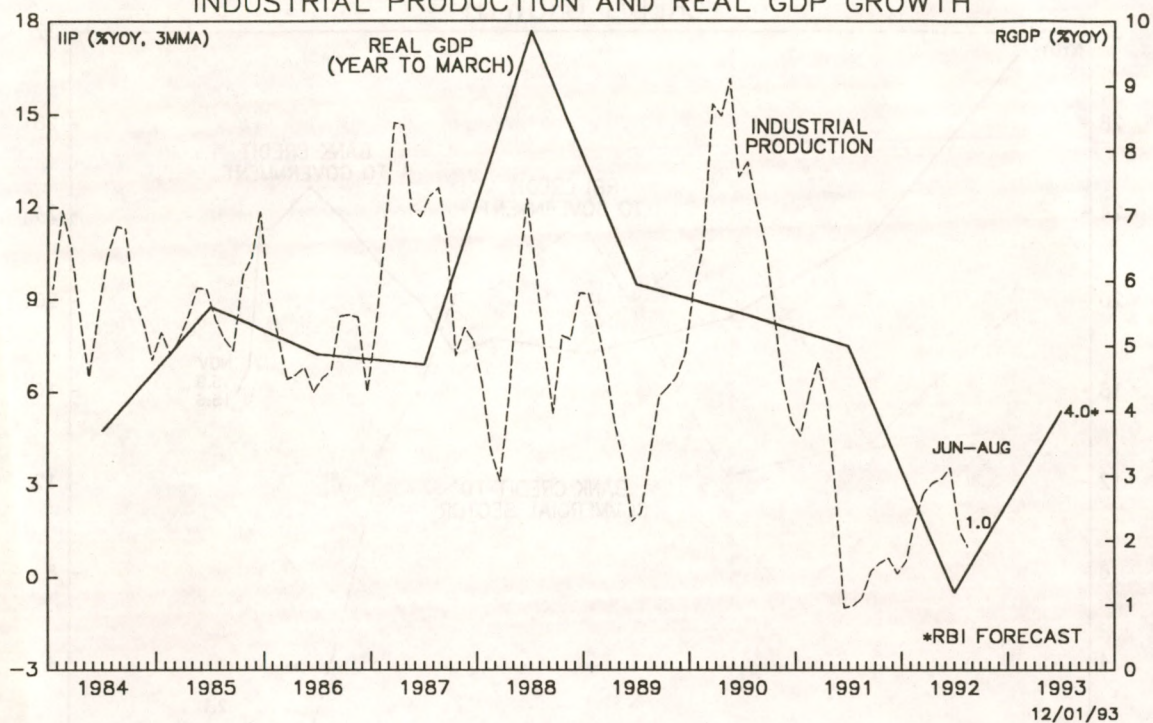


INDIA: CHART 5
CREDIT GROWTH

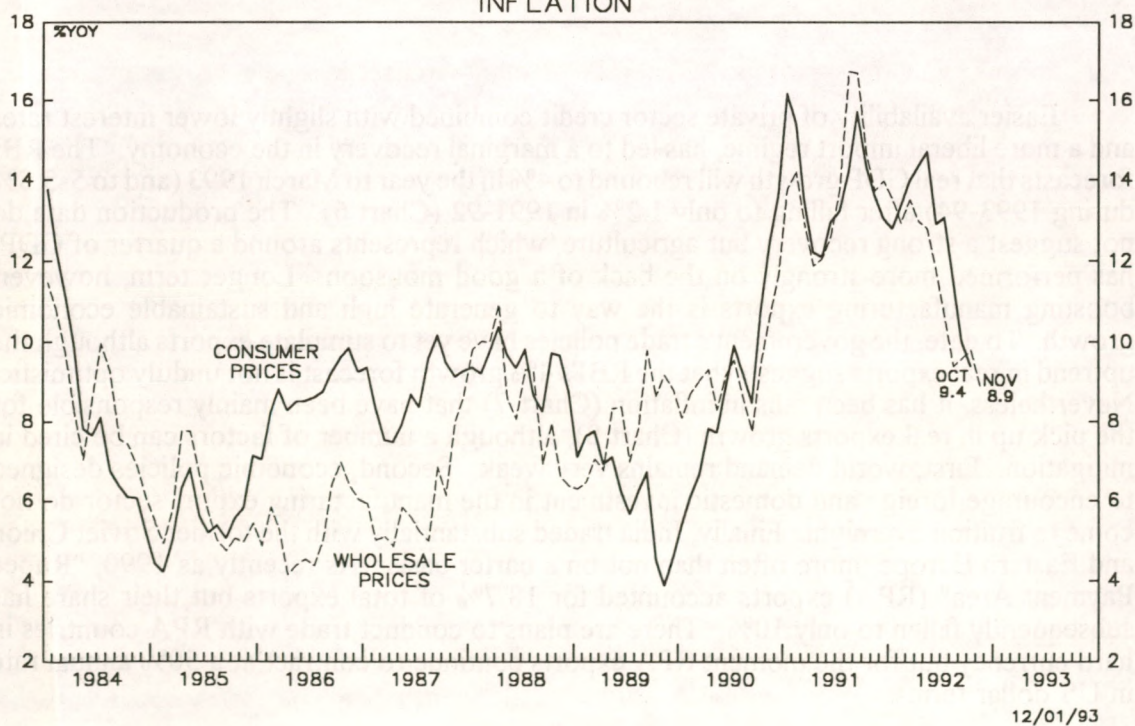


Easier availability of private sector credit combined with slightly lower interest rates and a more liberal import regime, has led to a marginal recovery in the economy. The RBI forecasts that real GDP growth will rebound to 4% in the year to March 1993 (and to 5-5.5% during 1993-94) after falling to only 1.2% in 1991-92 (Chart 6). The production data do not suggest a strong recovery but agriculture, which represents around a quarter of GDP, has performed more strongly on the back of a good monsoon. Longer term, however, boosting manufacturing exports is the way to generate high and sustainable economic growth. To date, the government's trade policies have yet to stimulate exports although the uptrend in real exports suggests that the RBI's 4% growth forecast is not unduly optimistic. Nevertheless, it has been falls in inflation (Chart 7) that have been mainly responsible for the pick up in real exports growth (Chart 8), although a number of factors can be cited in mitigation. First, world demand remains very weak. Second, economic policies designed to encourage foreign and domestic investment in the manufacturing export sector do not come to fruition overnight. Finally, India traded substantially with the former Soviet Union and Eastern Europe, more often than not on a barter basis. As recently as 1990, "Rupee Payment Area" (RPA) exports accounted for 18.7% of total exports but their share has subsequently fallen to only 10%. There are plans to conduct trade with RPA countries in hard currency but for the moment RPA exports continue to contract at a 50% annual rate in US dollar terms.

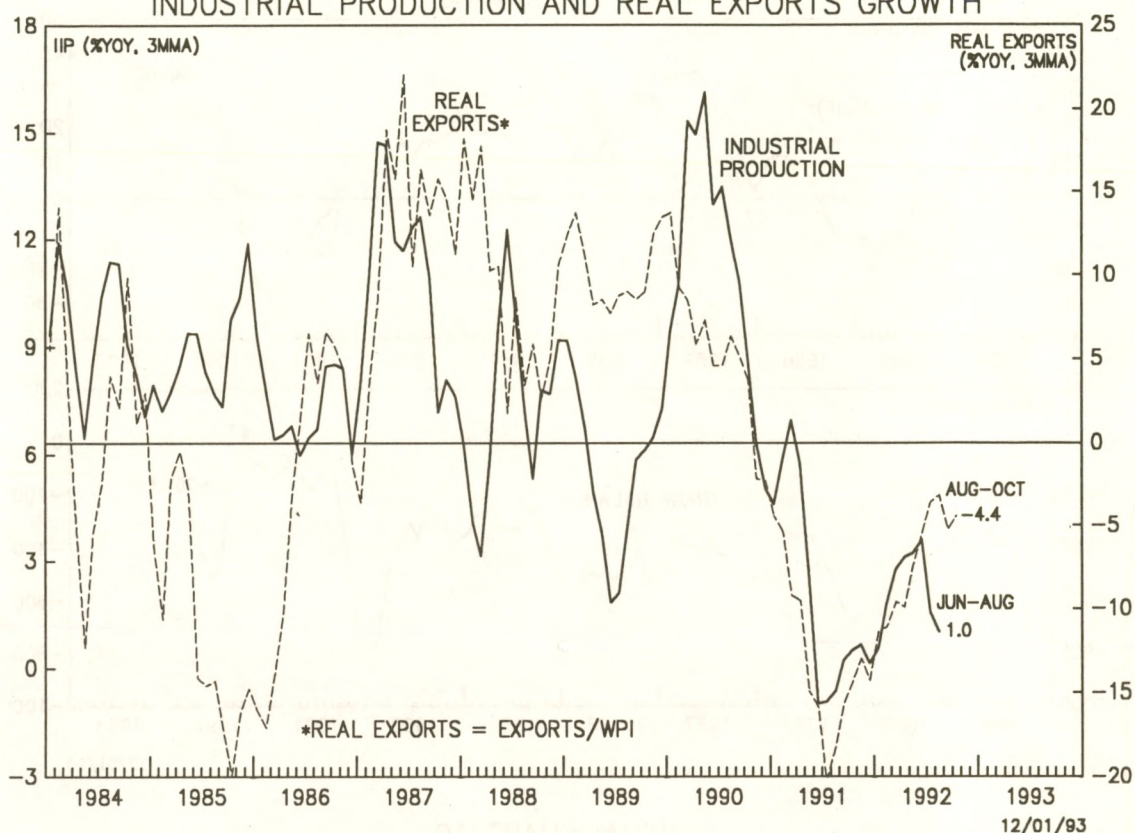
INDIA: CHART 6
INDUSTRIAL PRODUCTION AND REAL GDP GROWTH



INDIA: CHART 7
INFLATION

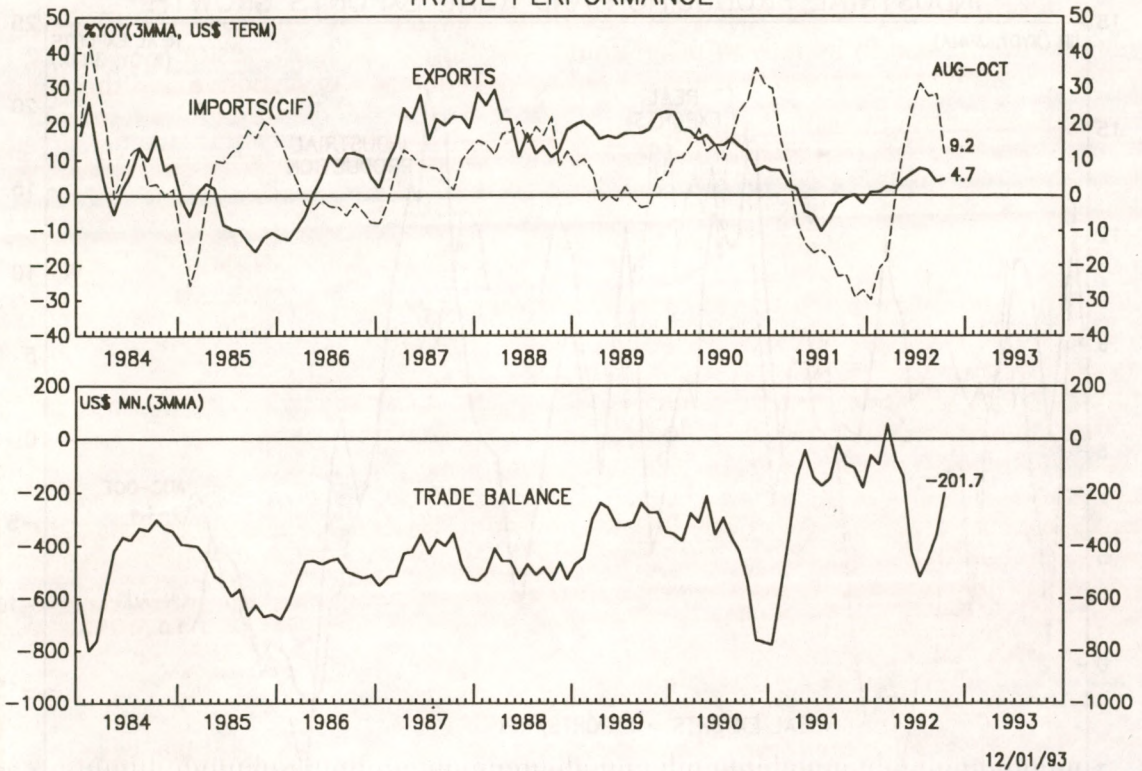


INDIA: CHART 8
INDUSTRIAL PRODUCTION AND REAL EXPORTS GROWTH

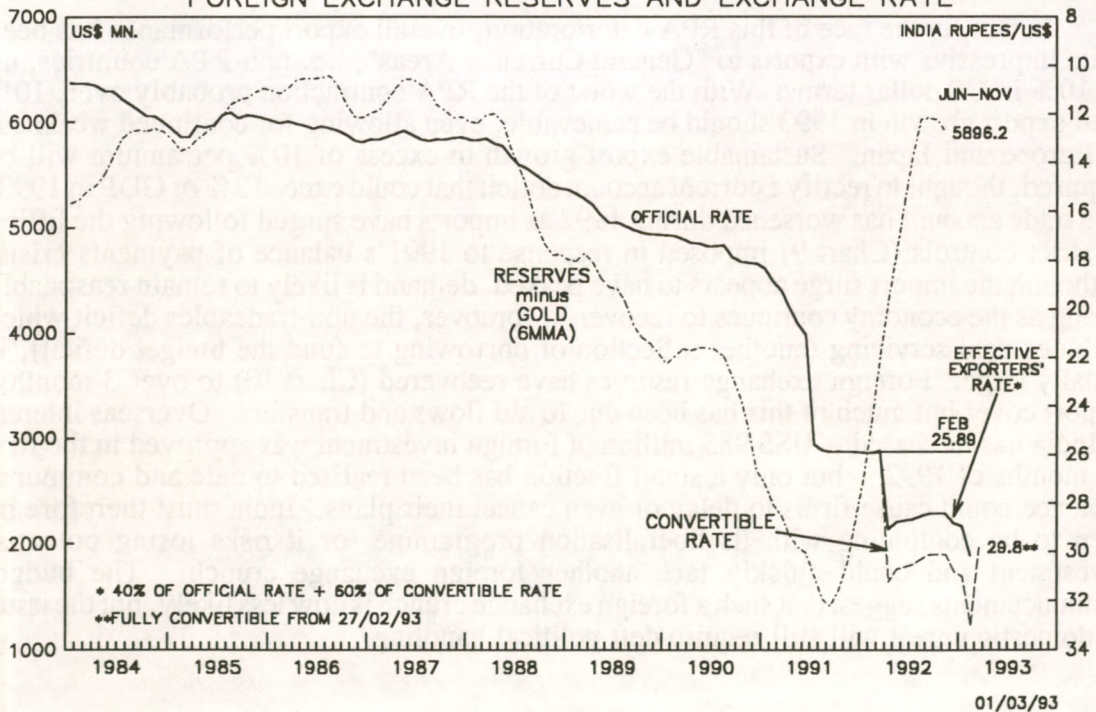


In fact, in the face of this RPA deterioration, overall export performance has been quite impressive with exports to "General Currency Areas", i.e. non-RPA countries, up by 10% in US dollar terms. With the worst of the RPA contraction probably over, 10% total export growth in 1993 should be achievable, even allowing for continued weakness in Europe and Japan. Sustainable export growth in excess of 10% per annum will be required, though, to rectify a current account deficit that could exceed 3% of GDP in 1993. The trade account has worsened during 1992 as imports have surged following the lifting of strict controls (Chart 9) imposed in response to 1991's balance of payments crisis. Although the import surge appears to have peaked, demand is likely to remain reasonably strong as the economy continues to recover. Moreover, the non-tradeables deficit which includes debt servicing (another reflection of borrowing to fund the budget deficit), is equally large. Foreign exchange reserves have recovered (Chart 10) to over 3 months' import cover but much of this has been due to aid flows and transfers. Overseas interest in India has increased -- US\$ 985 million of foreign investment was approved in the first 10 months of 1992 -- but only a small fraction has been realised to date and communal violence could cause firms to delay or even cancel their plans. India must therefore be seen to be continuing with its liberalisation programme, or it risks losing potential investment and could quickly face another foreign exchange crunch. The budget announcements suggest that such a foreign exchange crunch is now less likely, but the issue of domestic unrest will still require deft political handling.

INDIA: CHART 9
TRADE PERFORMANCE



INDIA: CHART 10
FOREIGN EXCHANGE RESERVES AND EXCHANGE RATE



CONCLUSION: February's budget was a key signal to the outside world that India remains committed to its reform programme. Restoring foreign investor confidence is particularly important given the adverse publicity generated by Ayodhya and the "Gilt Scandal," for in the absence of significant domestic financial sector reform, foreign capital will have to play an even greater role in generating manufacturing export capacity. This in turn is vital for the maintenance of a comfortable level of foreign exchange cover. Further measures over the next few years to reduce the budget deficit will be necessary (1) to demonstrate the government's resolve and (2) to free up further the financial sector by allocating a greater proportion of credit to commercial enterprises. Such measures could include a speeding up of the privatisation programme (which could raise around US\$ 1 billion this year), greater tax reform and additional subsidy cuts. However, areas such as defence and agricultural taxation will probably remain little touched, while the issue of massive overstaffing in the bureaucracy and state-owned enterprises promises to bring some bitter encounters. On the trade side, additional tariff reductions are likely and red-tape should be further trimmed, while exporters will also clearly be helped by the unification of the official and convertible exchange rates. (Exporters could previously exchange 60% of their foreign currency at a convertible rate and the remainder at an official rate of 25.89 Rupees to the US dollar. In the month leading up to the budget announcement, the convertible rate moved from 31.8 to 33 resulting in a 5% devaluation in the exporters' effective exchange rate. After the announcement, the Rupee convertible rate moved back in line with this implied effective rate.)

Assuming reform continues, or at the worst is not reversed by political turmoil, India should enjoy a mild economic expansion over 1993. Longer term, higher sustainable growth will only be attained if foreign capital is forthcoming, and if the selective reform process is extended to all areas of the economy.

MALAYSIA

A DOUBLE DIP SLOWDOWN IN PROSPECT.

Introduction

Recent data suggest that the Malaysian economy is still slowing down in the wake of the tight money policy of 1990-91. However this slowdown is probably only a temporary one as monetary growth subsequently accelerated through most of 1992, and this suggests there could be an upturn in nominal spending in the months ahead. Superficially, therefore, Malaysia appears to have solved its overheating problem of 1991-92, but in reality this is just a period of calm before the storm breaks again.

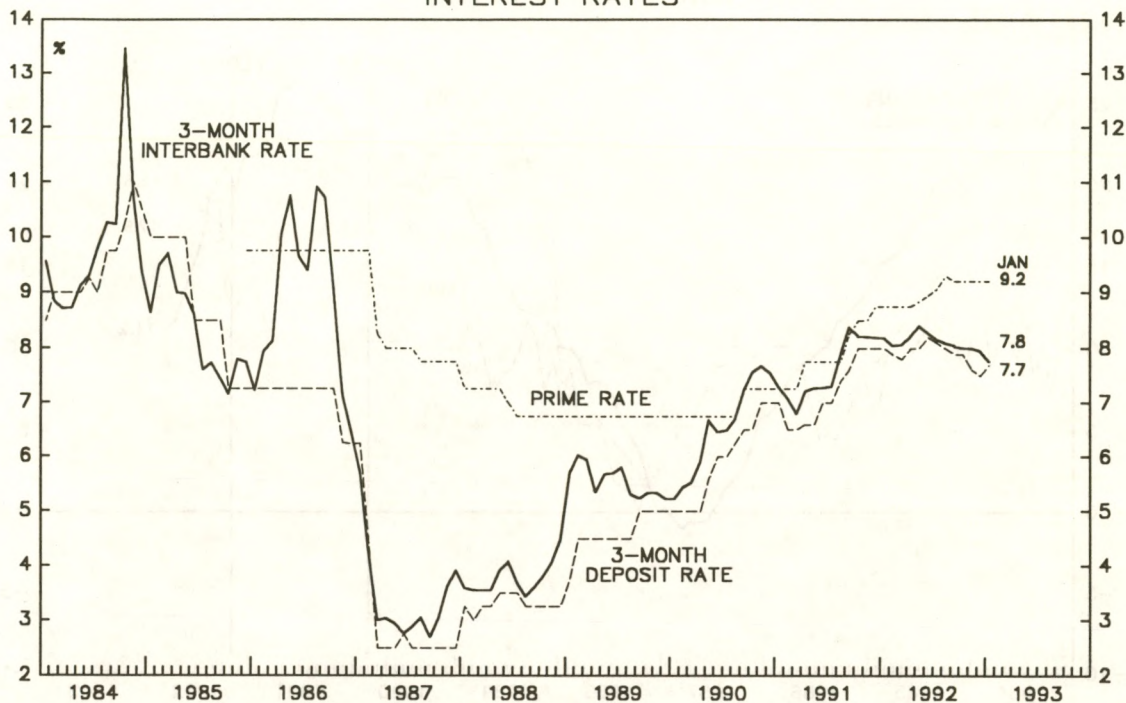
In the analysis which follows we will first document the slowdown in the economy and the apparent evidence of a retreat from overheating; second we will explain how Bank Negara Malaysia has been conducting monetary policy during 1992 and the consequences which this implies for the Malaysian economy in 1993. In summary, Bank Negara has unwittingly released the brakes too early and although there may be a window of easy liquidity for the next few months during which investment conditions will be favourable, later in 1993 as the symptoms of overheating re-appear it is almost certain that Bank Negara will be obliged to take further measures to complete the adjustment to the original problem. Most probably it will need to raise interest rates to curb monetary expansion, which will clearly cause a setback for the stockmarket and for the economy as a whole. But this will be the only way to deal fully with the excess domestic demand which has been the underlying problem of the economy since at least 1991. In short instead of purging itself in one single slowdown, Malaysia is likely to experience a double-dip slowdown.

The Evidence of Economic Slowdown

During the second half of 1992 the evidence of economic slowdown in Malaysia has been mounting. The early signs came in the wake of the imposition of direct controls on hire purchase lending and increases in interest rates in 1990-91 when the growth of finance company loans for hire purchase peaked in mid-1990 and started falling quite steeply (Charts 1 and 2). As interest rates rose further, total loans and advances of all banks, finance companies and merchant banks peaked out in mid-1991 and have subsequently slowed from 26% to 11.2% year-on-year (Chart 3). More recently manufacturing production has slowed from the double digit growth rates experienced in 1990-91 to 7.4% year-on-year in November (see Chart 4). Similarly, the pace of foreign and domestic investment in Malaysia has slowed. Chart 5 shows how the number of foreign investment projects approved by MIDA (the Malaysian Industrial Development Authority) has fallen from 901 in 1990 to 458 in 1992, while their value has also peaked out. Chart 6 shows the composition of these investment approvals in terms of their source — foreign or domestic. It is notable that foreign-sourced investment has held up while domestic-sourced investment projects have slowed significantly (from M\$ 12 bn. in 1991 to about M\$ 9 bn in 1992).

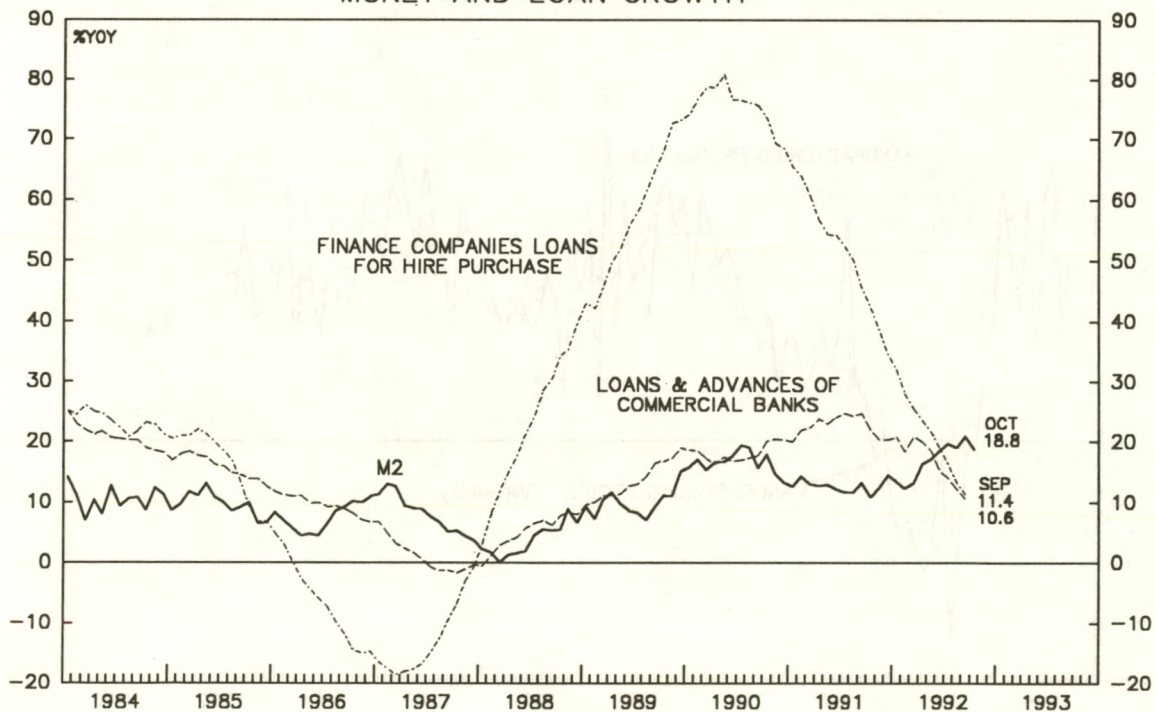
The external trade data also show clear signs of the economic slowdown. Imports (in US\$ terms) slowed from a 35% per annum growth rate in early 1991 to 7.5% by the third quarter of 1992 (Chart 7), or even more in M\$ terms (from nearly 40% p.a. to -3.5% p.a. over the same period). As a result, instead of import growth outstripping export growth, as it did between 1988 and 1991, export growth is now running comfortably ahead of import growth, and the trade balance has improved decisively (Chart 8). For example in October

MALAYSIA: CHART 1
INTEREST RATES



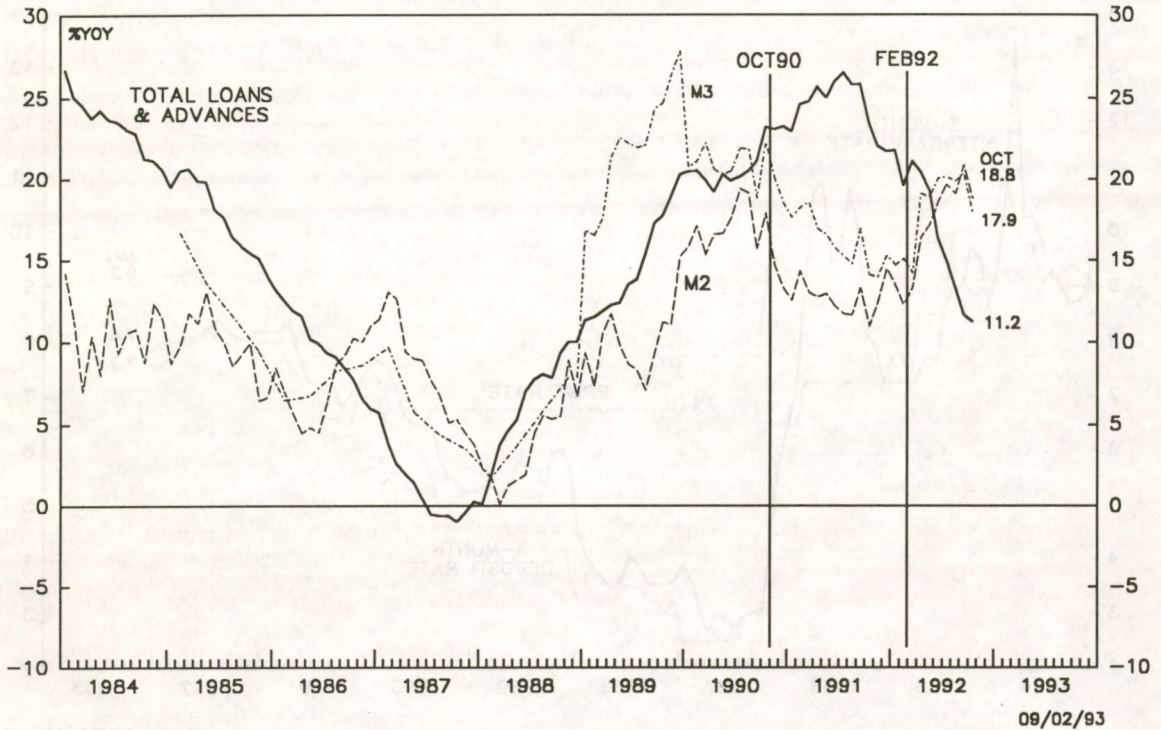
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MALAYSIA: CHART 2
MONEY AND LOAN GROWTH

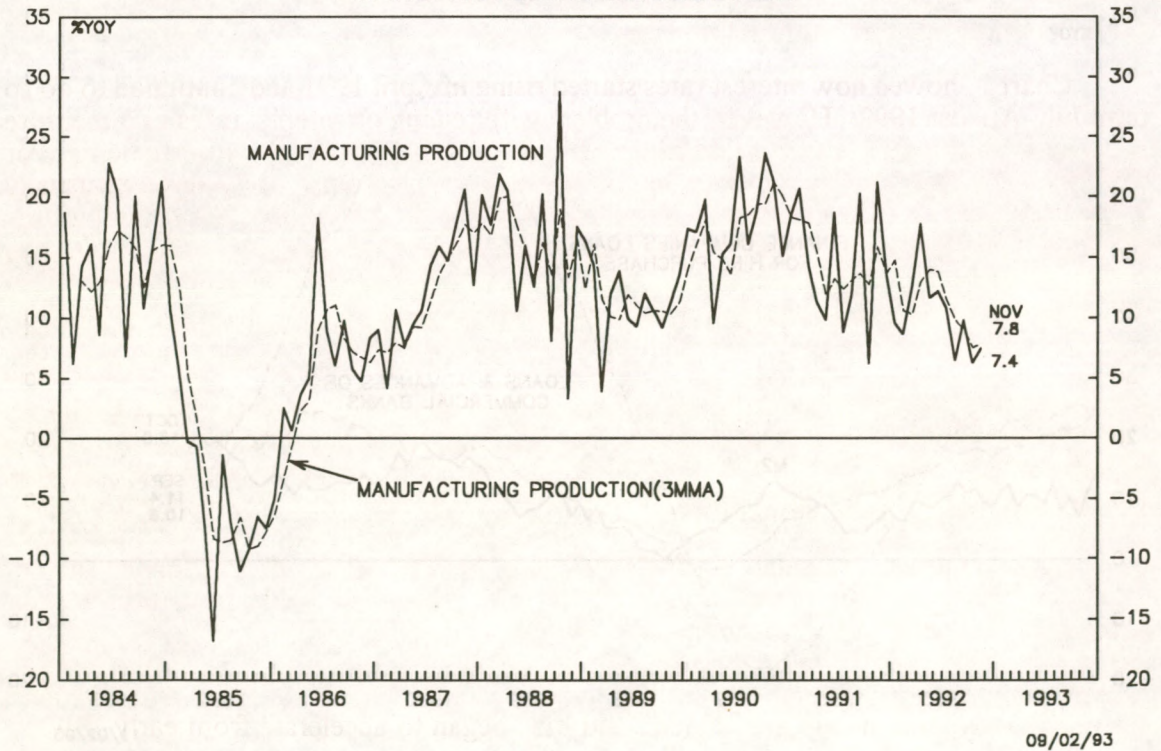


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MALAYSIA: CHART 3
MONETARY GROWTH



MALAYSIA: CHART 4
MANUFACTURING PRODUCTION



Malaysia's trade balance recorded a surplus of M\$ 563 million compared with a big deficit a year earlier. The October surplus marked the sixth successive month of surplus and brought the cumulative trade balance for the year to a surplus of M\$ 322 million. In local currency terms exports in October were 13% up on those a year earlier, while imports were down by 2.3%; over the first ten months of the year exports were up 9.6% while imports were virtually flat. All this is clear evidence of a cooling domestic economy while external demand remains reasonably firm considering the weakness of economic activity in Japan and Western Europe.

Other evidence of the domestic economic slowdown is easy to find. Car sales on the latest reading were down 21.3% (in December), and retail sales are suffering a pronounced period of weakness. There are, it is true, pockets of strength still surviving, such as consumer electronic sales which have continued very buoyant. However, for the time being, these are the exception rather than the rule. The economic downturn is generally pervasive as far as real variables are concerned.

However inflation remains stubbornly around 5% p.a. If nominal domestic demand had really been curbed, then one should have expected inflation to be slowing by now in the wake of the slowdown in the real economy. It would appear, therefore, that just at the time when inflation ought to have started to ease, something happened to cause it to remain around 5%. The re-acceleration of the M2 money supply would be consistent with this hypothesis. The real slowdown is therefore not likely to degenerate into a full-scale recession, and nor will the inflation rate fall despite the weakening of the real economy. It is more likely to be a temporary slowdown before another revival in domestic demand in the second half of 1993. The next section explains how monetary policy has created this unsatisfactory result.

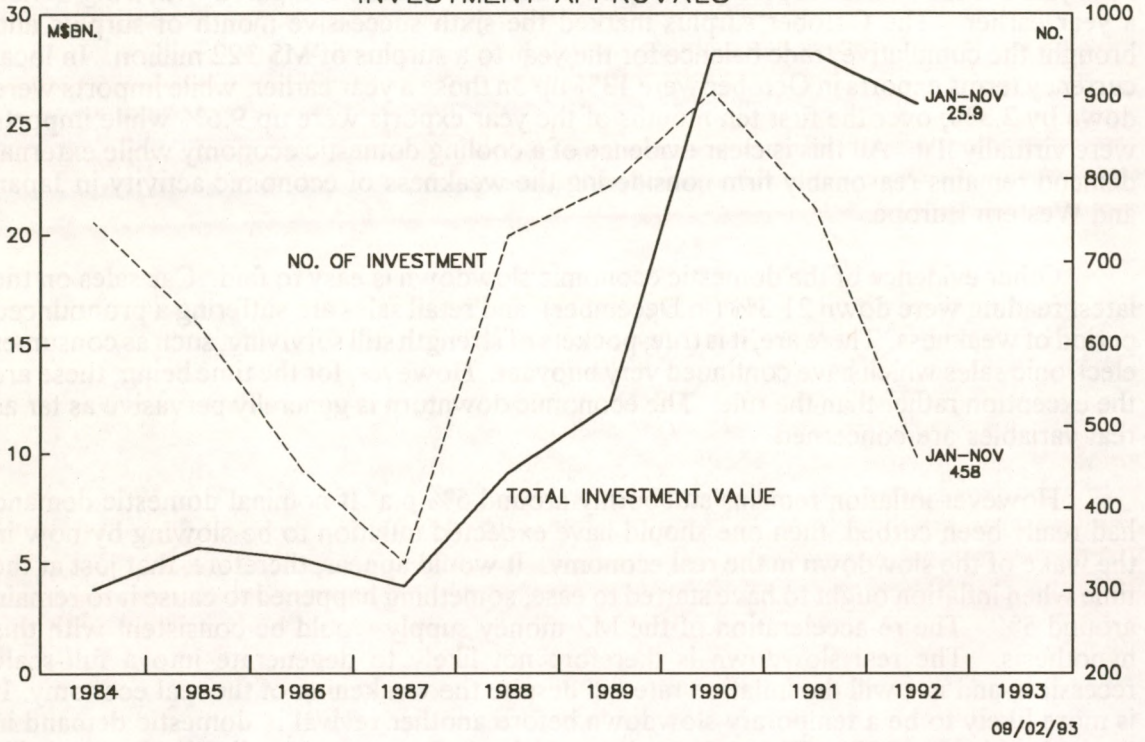
The Conduct of Monetary Policy in 1992

Chart 1 showed how interest rates started rising in April 1991 and continued to do so until July-August 1992. However, the problem with relying on interest rates as a measure of monetary ease or tightness is that the same level of nominal interest rates can be tight or easy, depending upon expectations about inflation in the economy. It is therefore usually more satisfactory to judge the stance of monetary policy by reference to the growth of the money supply data — generally a broad definition of money such as M2 or M3. On this criterion monetary policy was definitely easy until mid-1990, restrictive from mid-1990 to late 1991, and once again expansionary since early 1992.

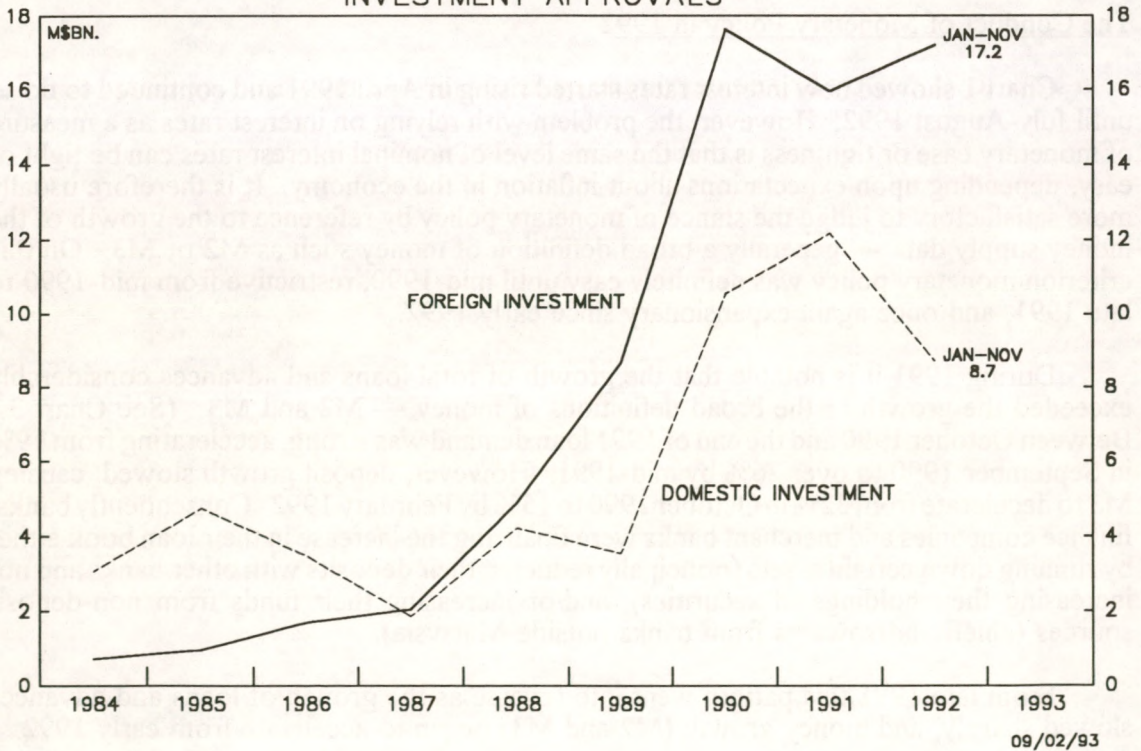
During 1991 it is notable that the growth of total loans and advances considerably exceeded the growth of the broad definitions of money — M2 and M3. (See Chart 3.) Between October 1990 and the end of 1991 loan demand was strong, accelerating from 19% in September 1990 to over 26% by mid-1991. However, deposit growth slowed, causing M3 to decelerate from 22% in October 1990 to 15% by February 1992. Consequently banks, finance companies and merchant banks were financing the increase in their loan book either by running down certain assets (principally reducing their deposits with other banks and not increasing their holdings of securities), and/or increasing their funds from non-deposit sources (chiefly borrowings from banks outside Malaysia).

From late 1991 this pattern went into reverse as the growth of loans and advances slowed sharply, and money growth (M2 and M3) began to accelerate from early 1992.

MALAYSIA: CHART 5
INVESTMENT APPROVALS



MALAYSIA: CHART 6
INVESTMENT APPROVALS



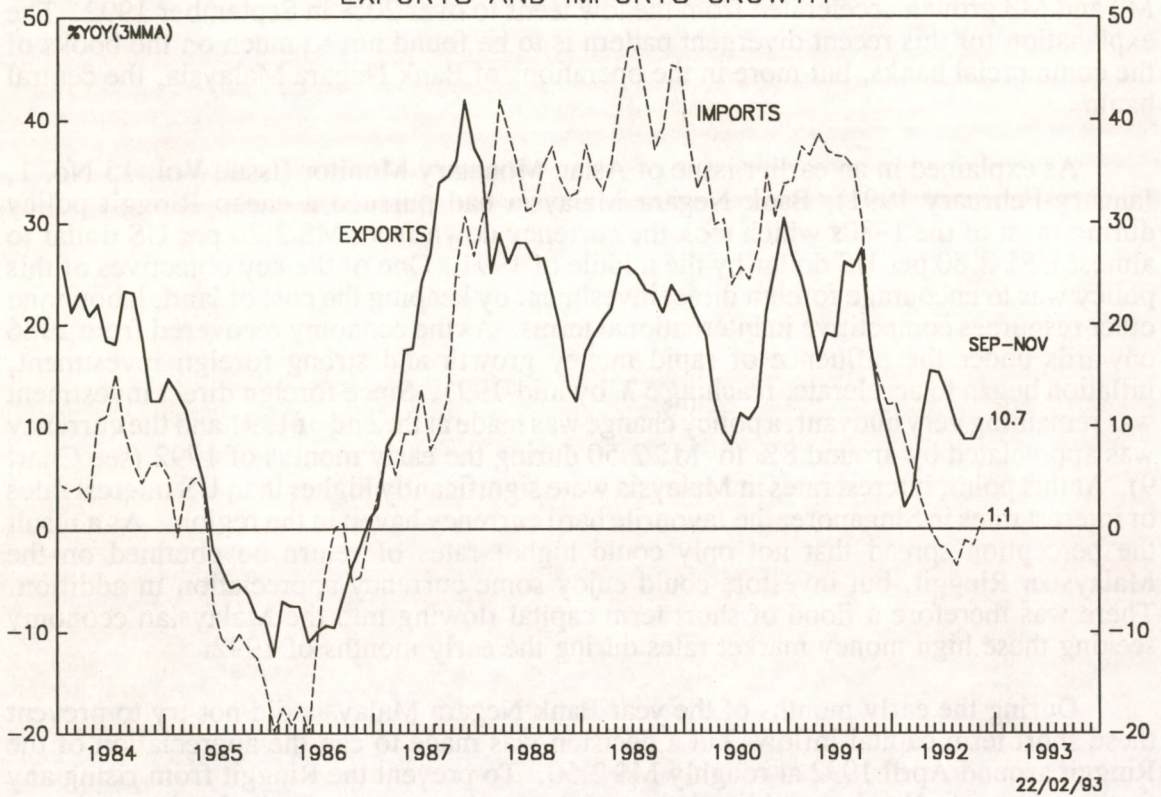
Between mid-1991 and October 1992 loan growth slowed from 26% to just 11.2%, while M2 and M3 growth accelerated from the low teens to over 20% in September 1992. The explanation for this recent divergent pattern is to be found not so much on the books of the commercial banks, but more in the operations of Bank Negara Malaysia, the central bank.

As explained in an earlier issue of Asian Monetary Monitor (Issue Vol. 15 No. 1, January-February 1991), Bank Negara Malaysia had pursued a cheap Ringgit policy during most of the 1980s which took the currency down from M\$ 2.20 per US dollar to almost US\$ 2.80 per US dollar by the middle of 1991. One of the key objectives of this policy was to encourage foreign direct investment by keeping the cost of land, labour and other resources competitive in international terms. As the economy recovered from 1986 onwards under the influence of rapid money growth and strong foreign investment, inflation began to accelerate, reaching 5% by mid-1991. Since foreign direct investment was remaining very buoyant, a policy change was made at the end of 1991 and the currency was appreciated by around 8% to M\$ 2.50 during the early months of 1992 (see Chart 9). At this point, interest rates in Malaysia were significantly higher than US interest rates or interest rates in Singapore, the favourite hard currency haven in the region. As a result the perception spread that not only could higher rates of return be obtained on the Malaysian Ringgit, but investors could enjoy some currency appreciation in addition. There was therefore a flood of short term capital flowing into the Malaysian economy seeking these high money market rates during the early months of 1992.

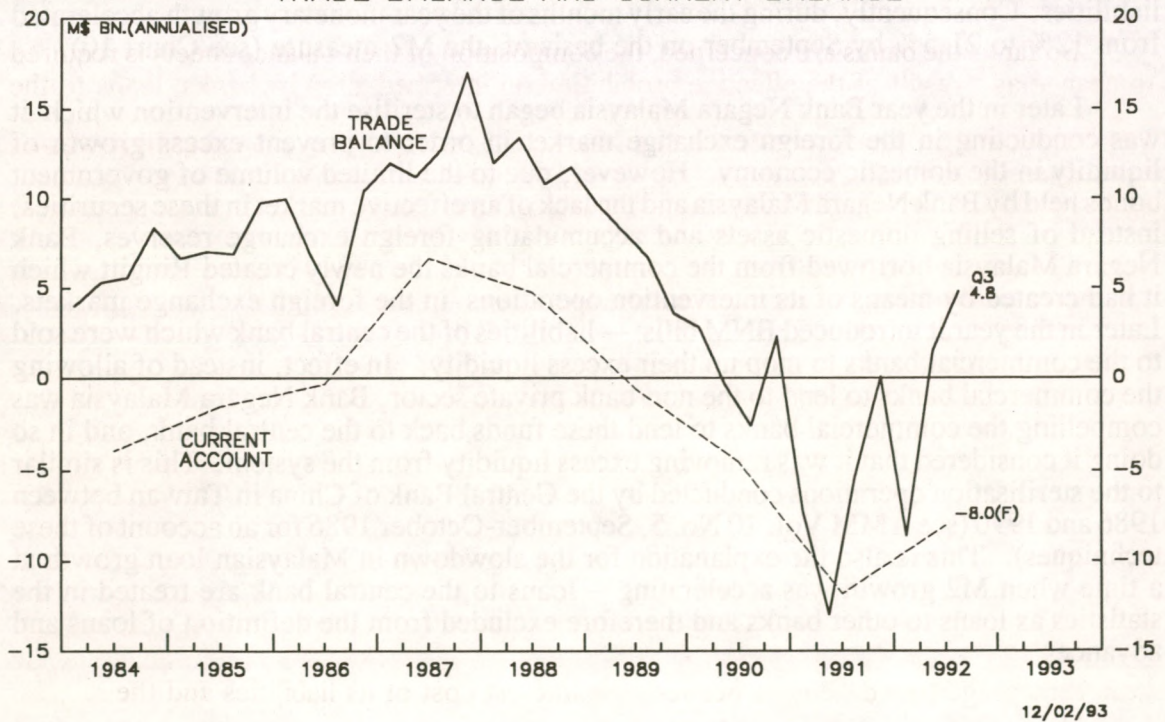
During the early months of the year Bank Negara Malaysia did not try to prevent these short term capital inflows but a decision was made to cap the appreciation of the Ringgit around April 1992 at roughly M\$ 2.50. To prevent the Ringgit from rising any further, the central bank was obliged to purchase foreign currency in the foreign exchange market, creating Ringgits in exchange, and enabling the banks to increase their assets and liabilities. Consequently, during the early months of the year monetary growth accelerated from 12% to 21.5% by September on the basis of the M2 measure (see Chart 10).

Later in the year Bank Negara Malaysia began to sterilise the intervention which it was conducting in the foreign exchange market in order to prevent excess growth of liquidity in the domestic economy. However, due to the limited volume of government bonds held by Bank Negara Malaysia and the lack of an effective market in these securities, instead of selling domestic assets and accumulating foreign exchange reserves, Bank Negara Malaysia borrowed from the commercial banks the newly created Ringgit which it had created by means of its intervention operations in the foreign exchange markets. Later in the year it introduced BNM bills — liabilities of the central bank which were sold to the commercial banks to mop up their excess liquidity. In effect, instead of allowing the commercial banks to lend to the non-bank private sector, Bank Negara Malaysia was compelling the commercial banks to lend these funds back to the central bank, and in so doing it considered that it was removing excess liquidity from the system. This is similar to the sterilisation operations conducted by the Central Bank of China in Taiwan between 1986 and 1990 (see AMM Vol. 10 No. 5, September-October 1986 for an account of these techniques). This is also the explanation for the slowdown in Malaysian loan growth at a time when M2 growth was accelerating -- loans to the central bank are treated in the statistics as loans to other banks and therefore excluded from the definition of loans and advances.

MALAYSIA: CHART 7
EXPORTS AND IMPORTS GROWTH



MALAYSIA: CHART 8
TRADE BALANCE AND CURRENT BALANCE



Balance Sheet Analysis

The fundamental problem raised by Bank Negara Malaysia's intervention and money market operations is whether such sterilisation can be effective in the long run. One way to approach this question is to analyse the balance sheet implications of these operations for the three main participants in the monetary system — the central bank, the banks and the non-bank private sector.

Starting with the non-bank private sector, faster monetary (M2) growth has meant an accumulation of monetary assets (mainly deposits) in the hands of firms and households. However, because banks have been prevented from lending to firms and households at the same rate, there has been a reduction in the amount of disintermediation via the commercial banking system. This doesn't mean that the demand for credit has lessened, only that it cannot be delivered via private commercial banks. We should therefore expect to see the emergence of other forms of intermediation such as direct issues of debt (and other types of paper) by corporations in the capital markets, and the growth of non-bank credit arrangements such as credit cooperatives or private credit circles. There is some anecdotal evidence that such activity is growing. In addition, as long as the Malaysian currency is regarded as liable to appreciate in value, Malaysian businesses should be expected to increase their borrowings of foreign currency, using the proceeds to buy assets in Malaysia. The crucial point is that, irrespective of the fact that bank deposit growth is not matched by loan growth, the private sector's monetary assets are growing rapidly and represent an increase in purchasing power to firms and individuals. Over time both firms and individuals can be expected to respond to this build-up of monetary assets in their portfolios in the traditional way i.e. by attempting to spend them on assets and on goods and services. Thus the fact that private sector borrowing from the banking system is being frustrated by the central bank's actions does not mean that the monetary expansion will ultimately have any less impact.

So far as the banks are concerned, the composition of their balance sheets is required to change as a result of the effective prohibition on intermediation by banks; loans to the Bank Negara Malaysia are increasing and loans to the private sector are gradually shrinking as a percentage of their assets. From the standpoint of their profits the banks will be relaxed because the quality of their balance sheets is improving. With respect to their profitability, they are simply responding to inducements (or moral suasion) by the central bank. So long as the assets they acquire at Bank Negara Malaysia are yielding a reasonable return above their cost of funds, they can be expected to go along with the central bank's policy. In any case, in view of the slowdown in the economy, the banks are anxious to repair the quality of their balance sheets. In time there may start to be concerns that the merchant banks and stockbrokers are enjoying the benefits of arranging numerous new debt and equity issues by the bank's traditional customers while the banks can only stand and watch.

Finally, with regard to Bank Negara Malaysia itself, the growth in foreign assets is matched partly by an increase in the monetary base (cash currency and the traditional reserve accounts of the banks), and increasingly by non-reserve deposits by banks, issues of Bank Negara bills (BNBs) and other liabilities to the banking system. If there is continuing upward pressure on the Malaysian Ringgit the central bank will find itself making balance sheet losses as the value of its foreign assets declines relative to its liabilities. Moreover, if it pays full money market rates on all its liabilities except currency, its traditional revenue from seignorage (the difference between the interest cost of its liabilities and the interest

earned on its assets) will diminish. Data from the 1992 budget suggest that Bank Negara Malaysia did indeed make less profit and transfer less to the Treasury in 1992. In effect Bank Negara Malaysia is bearing the cost of (1) the foreign exchange losses and (2) the inefficiencies engendered by preventing the banks from intermediating credit.

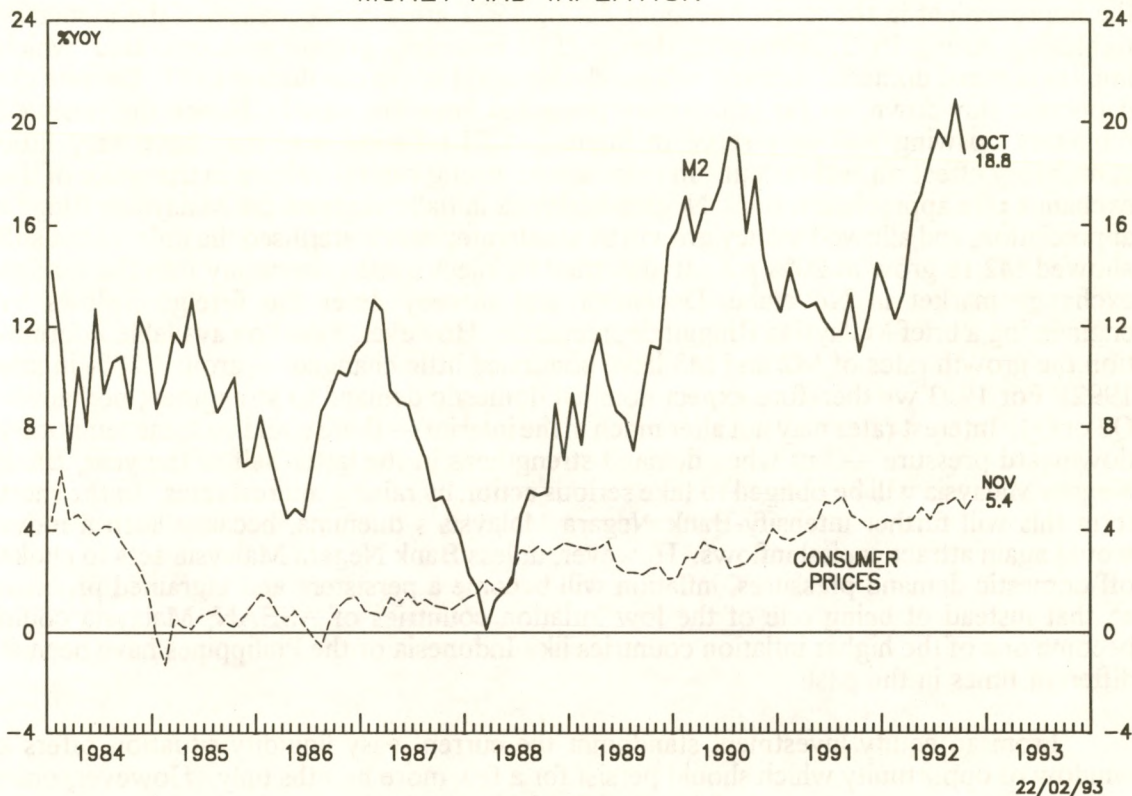
Our impression is that both the authorities and private sector regard the faster growth of deposits in 1992 as "hot" money, and therefore somehow temporary. The prevailing view appears to be that since the money derived from foreign inflows consequent upon the appreciation of the Malaysian Ringgit, the money will flow out again at some stage and therefore should not be regarded as a permanent addition to liquidity in the economy. (It was with this in mind that Bank Negara Malaysia deliberately engineered a period of weakness in the Malaysian currency in November in order to inject some uncertainty into the minds of the holders of the supposed hot money, thereby deterring any new inflows.) However, this is to make two basic errors. First, money does not "flow" in the metaphorical sense implied by the words inflow or outflow. The additional Malaysian Ringgit were only created as a result of Bank Negara Malaysia's own operations and the credit multiplier of the banks. Hence Bank Negara Malaysia itself would need to reverse the inflows by selling foreign exchange and absorbing (= destroying) domestic liquidity. Second, it is inconceivable that, even if capital flows were to reverse drastically in a fairly short timespan, Bank Negara Malaysia would wish to impose such a harsh monetary squeeze as would be implied by large non-sterilised sales of foreign exchange since this could imply a monetary slowdown from 20% p.a. to 0% (or even to a negative rate) within a very short timeframe, which in turn would have a very serious impact on the economy.

The Walters Critique

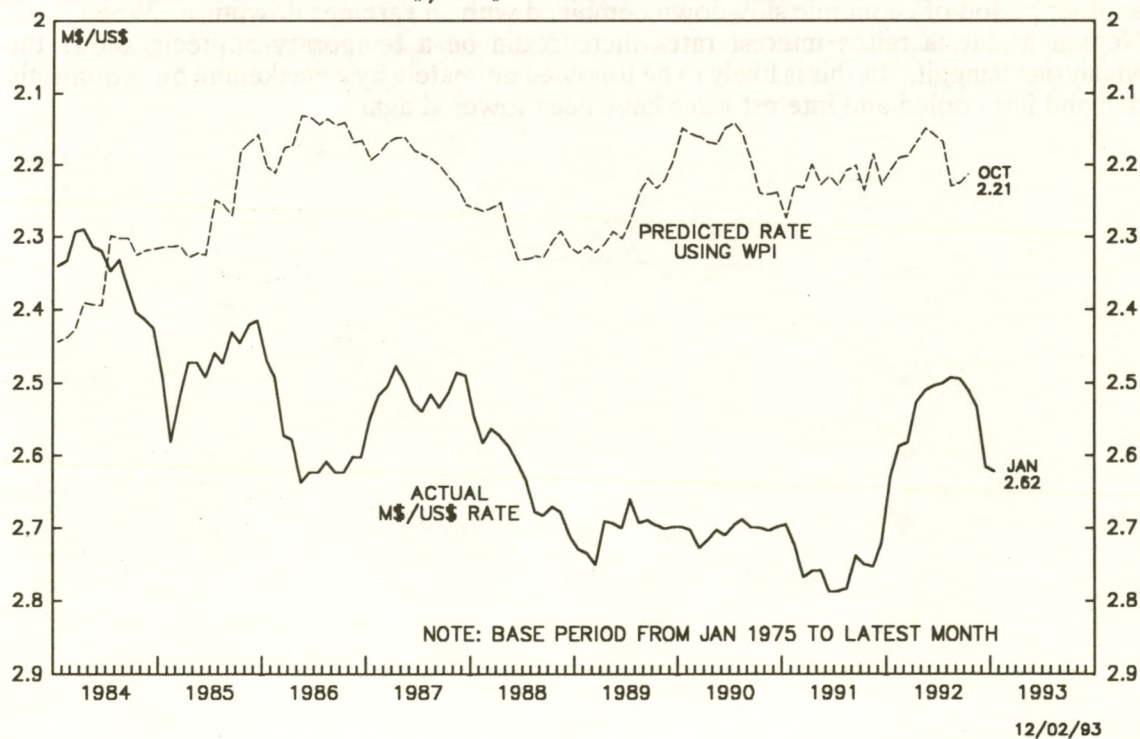
An alternative way to analyse this whole problem is to regard Malaysia as comparable to Spain in the ERM and apply the "Walters critique." In essence Malaysia is trying to hold its exchange rate down at an undervalued level, but it faces the dilemma that its interest rates are higher than the currencies against which it manages the Malaysian Ringgit, and this is attracting capital inflows which are being converted to rapid domestic money growth via Bank Negara Malaysia's own intervention operations. The right solution is to allow the exchange rate to float upwards far enough to discourage the inflows, at which point high interest rates and a high level of the exchange rate will act to deflate both domestic and external demand, which will enable interest rates to fall, which in turn may ultimately be followed by the exchange rate depreciating again. In short, external flexibility preserves a stable domestic price level. The converse solution, i.e. external rigidity with domestic inflation, is probably more painful in the long run since it takes longer to cure and affects all domestic prices, wages, and expectations, and changes the distribution of income. Given that Bank Negara Malaysia is politically constrained from raising interest rates and similarly inhibited from appreciating the exchange rate too far, it is being forced, willy-nilly into the second solution.

In conclusion, both the balance sheet analysis and the Walters critique suggest that Bank Negara Malaysia is underestimating the problems which it is storing up. The build-up of monetary assets (deposits) in the hands of the private sector is neither illusory nor temporary, and the presumed sterilisation of the commercial banks' assets does not eliminate the problem of excess liquidity in the hands of the non-bank private sector.

MALAYSIA: CHART 9
MONEY AND INFLATION



MALAYSIA: CHART 10
ACTUAL AND PREDICTED M\$/US\$ RATE USING PURCHASING POWER PARITY

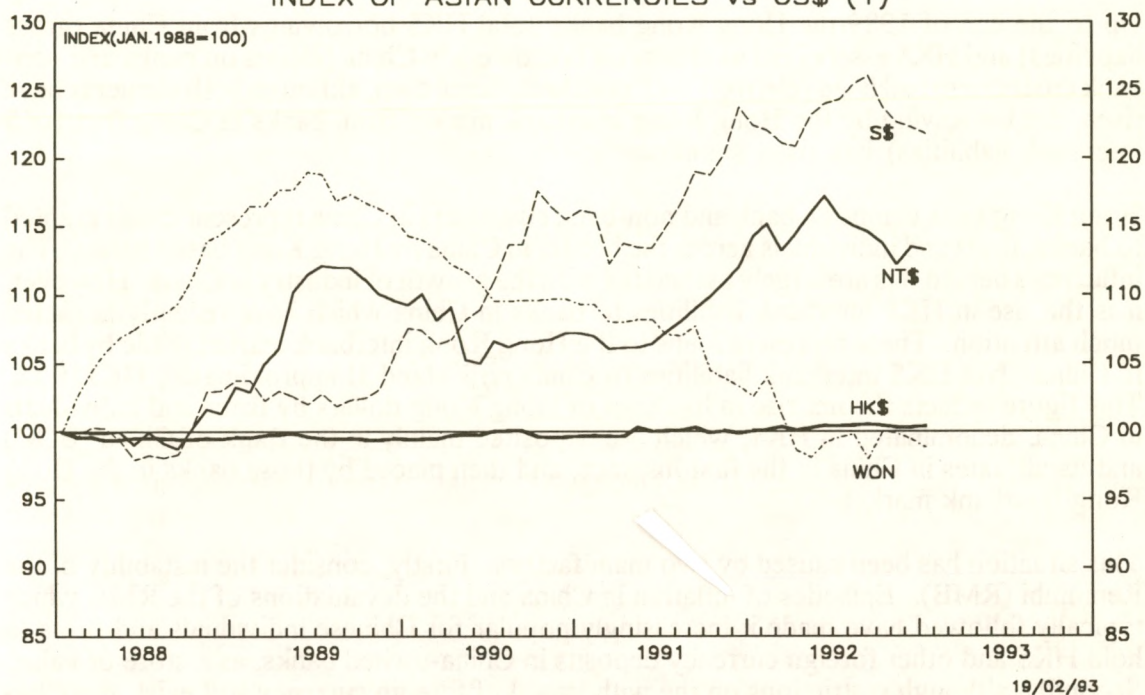


SUMMARY AND FORECAST: The slowdown in the Malaysian economy together with the improvement in the current account during 1992 are a consequence of the monetary tightening during 1991. However, during 1992 monetary growth re-accelerated, which implies nominal domestic demand will accelerate again sometime during 1993. Despite the economic slowdown, so far inflationary pressures have not eased. Hence the renewed monetary upswing will only serve to intensify CPI inflation, and may have very little stimulatory effect on real output. In response to strong capital inflows in the wake of the exchange rate appreciation Bank Negara Malaysia initially stopped the Malaysian Ringgit appreciation, and allowed money growth to accelerate; later it sterilised the inflows but still allowed M2 to grow at 20% p.a. It also tried to inject some uncertainty into the foreign exchange market in November-December and thereby deter the foreign inflows by engineering a brief Malaysian Ringgit depreciation. However, based on available information the growth rates of M2 and M3 have continued little changed — around 20% in late 1992. For 1993 we therefore expect nominal domestic demand to strengthen, perhaps in Q2 or Q3. Interest rates may not alter much in the interim — there could be some temporary downward pressure — but when demand strengthens in the latter half of the year, Bank Negara Malaysia will be obliged to take serious action by raising interest rates. In the short term this will further intensify Bank Negara Malaysia's dilemma, because such a move would again attract capital inflows. However, unless Bank Negara Malaysia acts to choke off domestic demand pressures, inflation will become a persistent and ingrained problem so that instead of being one of the low inflation countries of ASEAN, Malaysia could become one of the higher inflation countries like Indonesia or the Philippines have been at different times in the past.

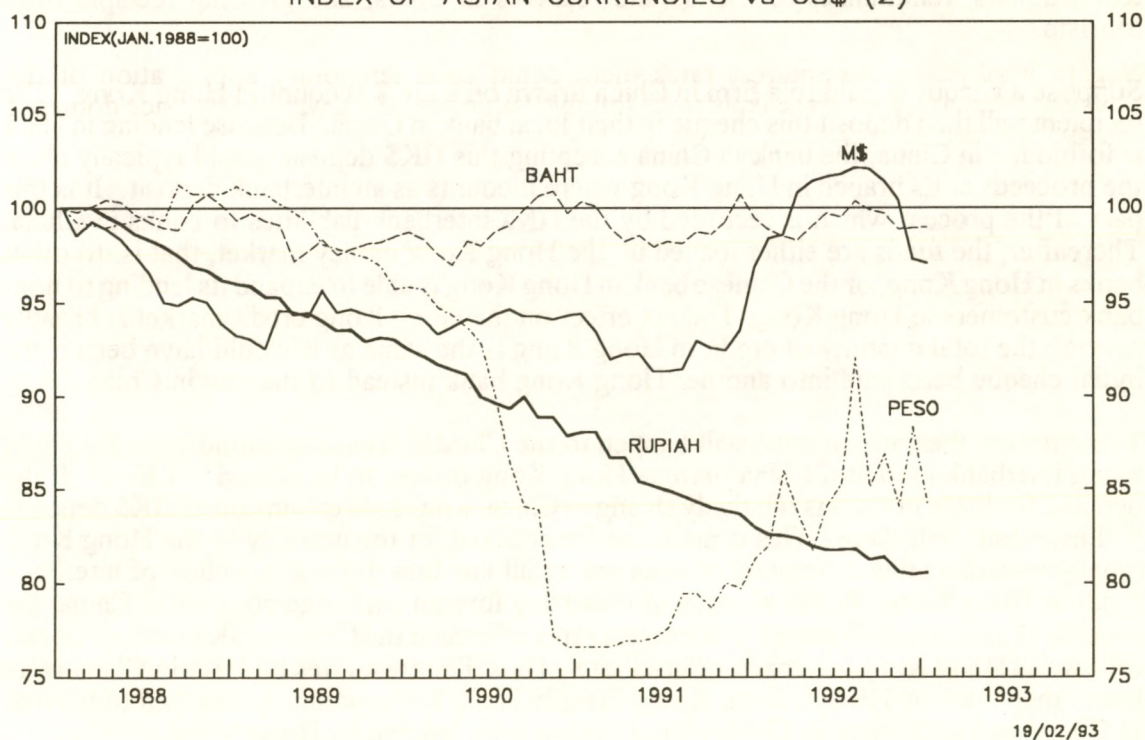
From an equity investment standpoint the current easy liquidity situation offers a window of opportunity which should persist for a few more months only. However, once inflationary pressures start to build up and Bank Negara Malaysia takes action to counter them, the outlook would deteriorate sharply with higher interest rates and the prospect of another period of economic slowdown combined with an earnings downturn. When Bank Negara Malaysia raises interest rates there could be a temporary appreciation of the Malaysian Ringgit, but this is likely to be followed ultimately by a weakening once domestic demand has cooled and interest rates have been lowered again.

INDEX OF ASIAN CURRENCIES vs US Dollar.

INDEX OF ASIAN CURRENCIES vs US\$ (1)



INDEX OF ASIAN CURRENCIES vs US\$ (2)



HONG KONG: MISPLACED CONCERN OVER CHINESE HK\$ DEPOSITS

Up to the end of 1989 the Hong Kong banks' total HK\$ borrowings from China (gross liabilities) and HK\$ assets held as claims on borrowers in China (claims on banks and non-bank customers) had been relatively well matched. Since then, although both elements have risen, net borrowing by the Hong Kong interbank market from banks in China (net HK\$ interbank liabilities) has risen significantly.

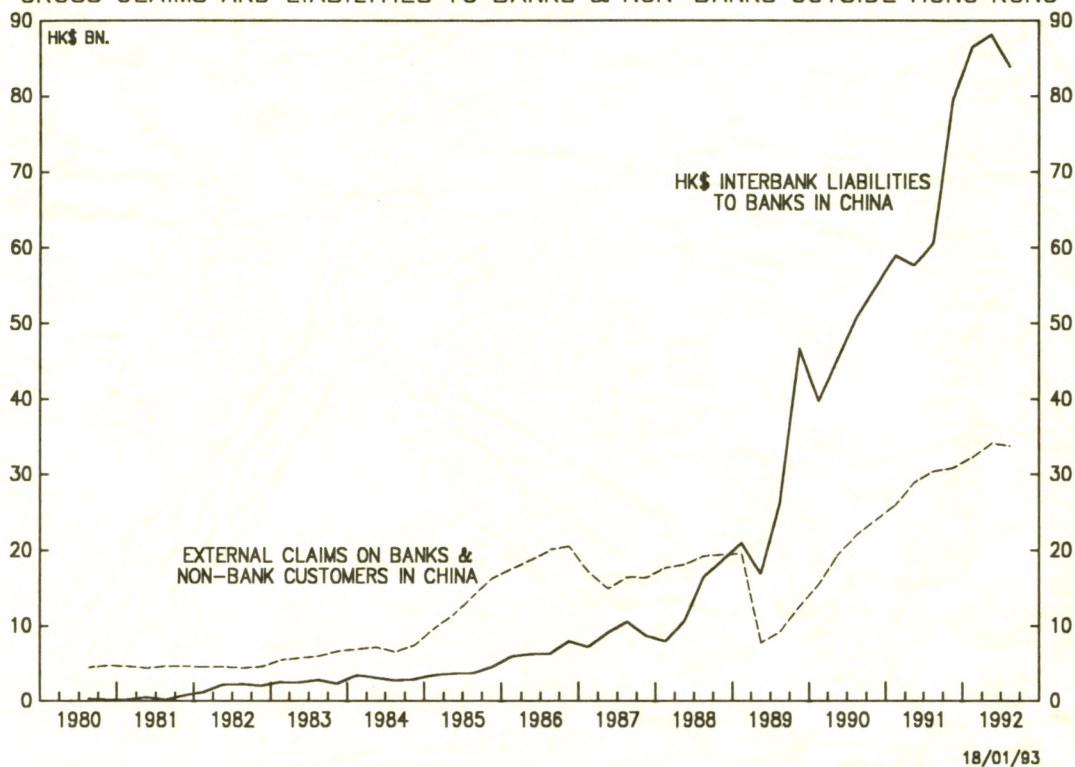
Hong Kong bank claims on bank and non-bank customers in China represent credit granted to banks, firms and individuals across the border in China by Hong Kong based banks. The influences behind this are largely associated with the growth of industry in China. However, it is the rise in HK\$ interbank liabilities to banks in China which have recently attracted much attention. These represent loans to the Hong Kong interbank market made by banks in China. Net HK\$ interbank liabilities to China now stand at approximately HK\$50 bn. This figure reflects the net rise in holdings of Hong Kong dollars by firms and individuals in China, denominated in HK\$, which are deposited mainly in the Bank of China (BOC) and its affiliates in China in the first instance, and then placed by those banks in the Hong Kong interbank market.

This situation has been caused by two main factors. Firstly, consider the instability of the Renminbi (RMB). Episodes of inflation in China and the devaluations of the RMB which typically followed have made it increasingly popular for Chinese individuals and firms to hold HK\$ and other foreign currency deposits in China-owned banks, as a store of value. Secondly, although restrictions on the withdrawal of foreign currency still exist, there has no doubt been a rise in the availability of Hong Kong dollars through the general increase in foreign direct investments in China, the growth of exports from China paid for in Hong Kong dollars, remittances to friends and relatives in China, and growing receipts from tourism.

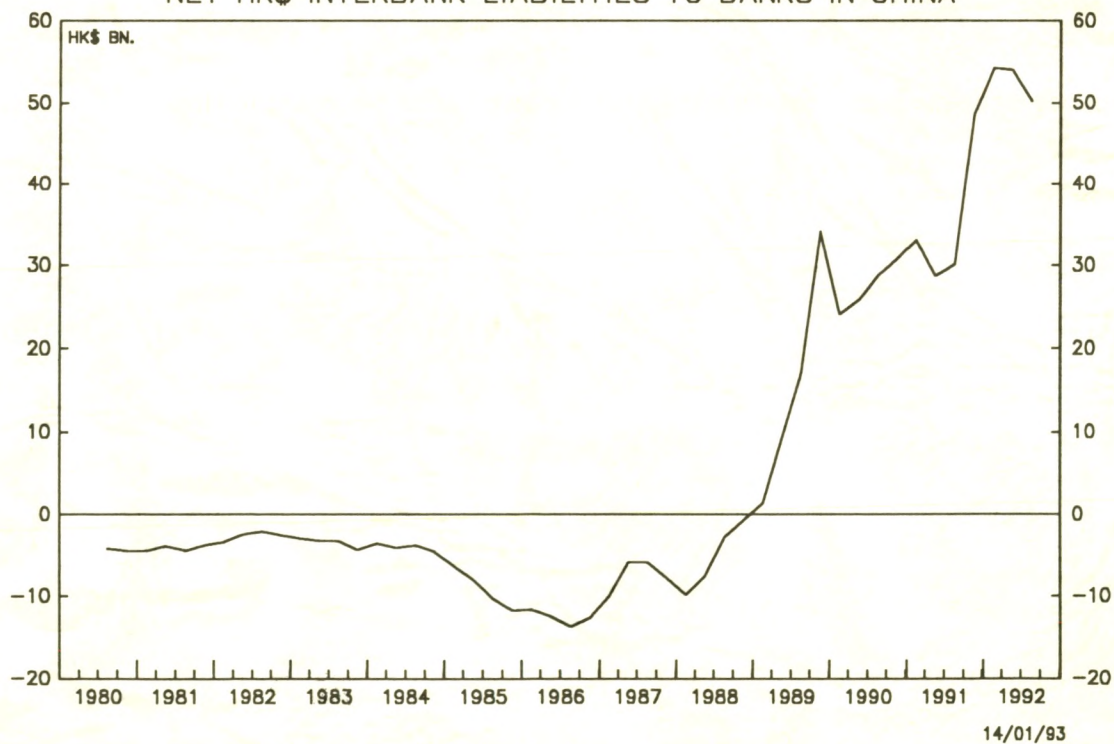
Suppose a cheque is paid to a firm in China drawn on a HK\$ account in Hong Kong. The recipient will then deposit this cheque in their local bank in China. Because lending in HK\$ is forbidden in China, the bank in China accepting this HK\$ deposit would typically place the proceeds at its branch in Hong Kong where it counts as an interbank deposit. It is this part of the process which is recorded by the HK\$ interbank liabilities to banks in China. Thereafter, the funds are either loaned in the Hong Kong money market, that is, to other banks in Hong Kong, or the Chinese bank in Hong Kong is able to expand its lending to non-bank customers in Hong Kong. The net effect on the Hong Kong credit market is broadly neutral; the total quantity of credit in Hong Kong is the same as it would have been if the initial cheque been paid into another Hong Kong bank instead of the one in China.

The question then arises: what will happen to the Chinese source of liquidity to the Hong Kong interbank market if China permits Hong Kong dollars to be loaned in China? If the demand for loans in HK\$ is relatively strong in China, a multiple expansion of HK\$ deposits will establish itself there. This is no cause for concern for the liquidity of the Hong Kong money market as this development does not entail any loss in the availability of interbank funds in Hong Kong. In the absence of distorting foreign exchange controls in China, the process of arbitrage will ensure that interest rates offered in the Chinese HK\$ market closely follow the Hong Kong interbank offered rate. Thus if interest rates on HK\$ in China were lower than rates on HK\$ in Hong Kong, firms in Hong Kong would be induced to borrow in China, and/or lenders in China would switch their lending to Hong Kong.

GROSS CLAIMS AND LIABILITIES TO BANKS & NON-BANKS OUTSIDE HONG KONG



HONG KONG NET HK\$ INTERBANK LIABILITIES TO BANKS IN CHINA





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CHINA'S STOP-GO BUSINESS CYCLE -- A COMPARISON WITH JAPAN IN THE BRETTON WOODS ERA.

Introduction

The Chinese economy is in the midst of a rapid expansion which springs from a renewed emphasis on economic reform and nearly three years of monetary growth in the region of 30% p.a. The economy is already showing the early signs of overheating and the likely outcome is that inflation will accelerate in 1993 and 1994 to a point where the Chinese authorities will be forced to take action by curbing credit expansion and possibly imposing import controls.

The Chinese business cycle is best understood as deriving from the fact that the country operates a fixed exchange rate mechanism, although there have been some deviations from this model over the past few years. However, the fixed exchange rate paradigm is the best analytical framework with which to start an analysis, and the most useful comparative model for the Chinese business cycle in the 1990s and in the early part of the next century perhaps is the case of Japan during the years 1949 to 1971. Over this period Japan's exchange rate was fixed at Yen 360 per US\$, although under the Bretton Woods system small deviations were allowed on either side of the fixed parity. During these years the Japanese economy exhibited rapid real economic growth averaging 9.1% p.a. in real terms, but there were wide cyclical fluctuations with periods of real growth as high as 15% p.a. and periods of slower growth as low as 0%. (See Chart 1). Inflation of asset prices and goods and services prices generally followed the monetary cycle with asset prices rising ahead of, and concurrent with economic expansion, and goods and services prices rising in the wake of economic expansion. Conversely, declines or slowdowns in asset prices generally preceded business downturns, while consumer prices followed in tandem after slowdowns in business activity. Although China's markets in assets (primarily land and securities), credit instruments, and private property markets generally are only in their infancy, nevertheless we can already see parallels with the Japanese example. The parallel is also extended to the balance of payments where, like Japan, China maintains foreign exchange controls both on current account transactions and on capital account transactions, but shows the intention of gradually lifting those controls as the country progresses towards a more liberal framework for trade and capital transactions.

This article will outline the essential features of the standard business cycle deriving from the maintenance of a fixed exchange rate system, illustrating the theoretical model by reference to the historical case of Japan and the more recent experience of China. The discussion will then focus on certain key issues such as the use of interest rates, the availability or non-availability of certain kinds of assets as inflation hedges, the existence of foreign

CHART1: JAPAN 1954-72

MONEY, OUTPUT AND PRICES

26/03/93

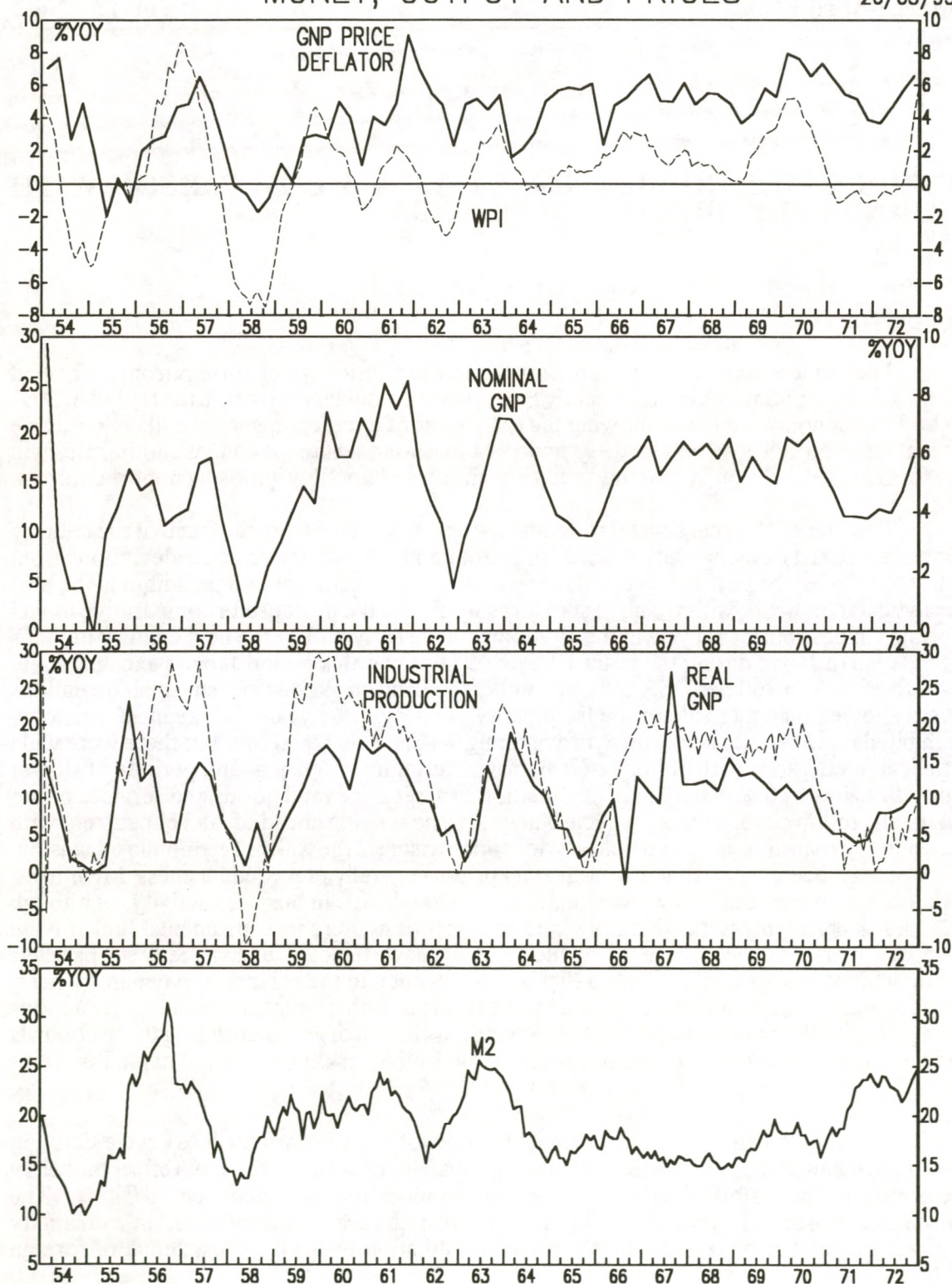
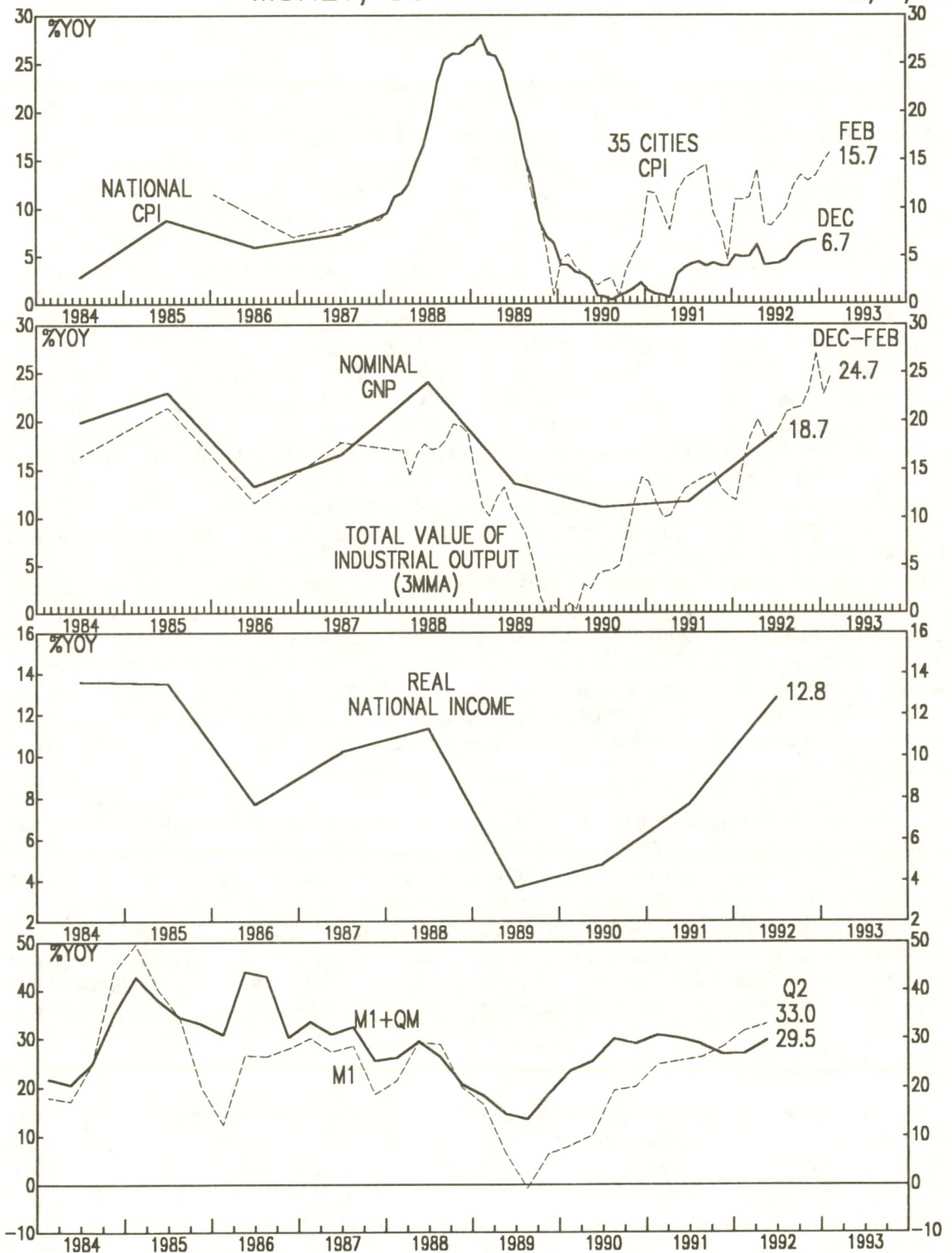


CHART 2: CHINA 1984-93 MONEY, OUTPUT AND PRICES

26/03/93



exchange controls, the existence of a two-tier market for foreign exchange in China, and the phenomenon of a differential inflation rate as between traded goods prices and non-traded goods prices.

Essential Features of Business Cycles Based on Fixed Exchange Rates.

Fixed exchange rate systems operated by central banks inevitably give rise to monetary fluctuations which in turn translate into fluctuations in the business cycle. These in turn lead to accelerations and decelerations in the rate of inflation. The mechanism underlying this business cycle stems from the central bank's need to maintain equilibrium in the balance of payments at the fixed exchange rate. Assume that a country is experiencing a surplus on its balance of payments, i.e. a surplus of foreign currency being offered for domestic currency in the local foreign exchange market. To prevent that country's exchange rate from appreciating, the central bank must purchase the surplus foreign exchange being offered on the foreign exchange market from sellers -- resident or non-resident. Such central bank purchases will be paid for by credits of domestic currency to the reserve accounts of commercial banks in that country. This will give those banks excess reserves in domestic currency which they can lend out to commercial customers. The banks' expansion of lending leads to an acceleration of monetary growth, which in turn enables the private sector to spend more on assets, and on goods and services. As economic activity rises in response to this increased expenditure, the country will tend to suck in more imports, which in turn will cause the balance of payments to deteriorate. As inflation builds up the country will also become less competitive at the fixed exchange rate, and in due course the balance of payments will deteriorate further to a position where instead of a net surplus of foreign currency on the local foreign exchange market there will be a surplus of domestic currency. This will require the central bank to intervene again, given its obligation to maintain a fixed exchange rate -- this time buying domestic currency and selling foreign currency. On this occasion the purchases of domestic currency will be met by the commercial banks having to debit their reserve accounts at the central bank, which in turn will force them to cut back on their lending and as a result monetary growth will decelerate or decline. Thereafter the trends described above for the real economy, the trade account, and inflation will all go into reverse until the whole cycle is ready to repeat itself.

Asset prices typically start to rise soon after monetary growth accelerates and may continue to rise until monetary growth peaks whereupon they will start to decline or at any rate rise at a substantially lower rate. Similarly prices of goods and services as reflected in the GNP deflator, or the wholesale price index, or the consumer price index, typically rise in the wake of a business cycle rise and decelerate, or fall, in the wake of a business cycle contraction. An extended discussion of the behaviour of asset prices and consumer prices in Japan during the post war period can be found in AMM Vol. 14 No. 3, May-June 1990 ("The Relation between Asset Price Inflation and Goods and Services Price Inflation").

The Case of Japan, 1949-71

In the case of Japan between 1949 and 1971 the operation of the mechanism described above is very clear. It is illustrated in Charts 1 and 3 which show the behaviour of Japanese money, output and prices, as well as the behaviour of the main components of the current account of the Japanese balance of payments, and the consequent fluctuations of Japanese foreign exchange reserves. Since capital controls were in effect in Japan throughout the Bretton Woods era, net private capital flows were never allowed to become a determining feature of the balance of payments. Throughout the years 1949-68 Japan's trade and current

accounts fluctuated from surplus to deficit. The main counterpart to these surpluses and deficits was a change in the central bank's international reserves, therefore typically the surpluses were associated with monetary accelerations, while the deficits were associated with monetary slowdowns. Only after 1968 when inflation in the USA began to rise significantly did Japan develop a chronic current account surplus. It was this surplus which led to a huge build-up of Japan's foreign exchange reserves in 1971 (See Chart 3), and increasingly put huge strains on US-Japanese trade relations as well as on the Bretton Woods fixed exchange rate system itself. Finally, the size of Japan and other countries' current account surplus and the size of Japan's potential claims on the US gold stock at the official rate of US\$ 35 per ounce forced the Nixon administration in the US to close the gold window in August 1971, effectively bringing an end to the Bretton Woods system. In short, the Japanese business cycle in the years 1949-71 was largely a dance of the dollar -- i.e. a consequence of fluctuations in Japan's balance of payments, which in turn derived from the fixed exchange rate and monetary accelerations or decelerations in the United States.

The Case of China, 1978-93

In the case of China since 1978 the business cycle has operated in broadly the same manner as in the mechanism described above although certain qualifications need to be made. For example, China's state-owned banks do not operate on a reserve requirement ratio, and hence their lending does not increase as a direct consequence of the People's Bank of China (the central bank) acquiring foreign exchange reserves. Nevertheless, the People's Bank of China's foreign exchange position does have a significant influence on its willingness to allow the banks to expand credit. To date, China has experienced two complete cycles (i.e. two expansions and two contractions), and is reaching the climax of the third episode of expansion. Like Japan in the 1950s and early 1960s, China's average real growth rate has shown a tendency to accelerate over the past decade as economic reforms have progressed. Chart 2 shows the behaviour of China's monetary aggregates, various measures of output in nominal and real terms, and inflation. In the first expansion (1983-85) under Hu Yao-bang there was only a limited degree of price liberalisation, mainly of food and other agricultural commodities, while industrial and manufactured products remained subject to widespread price controls. Private ownership remained the exception rather than the rule, and as a result China's real GNP growth rate peaked at over 13%. In contrast to Japan which maintained a rigidly pegged rate at Yen 360 per US dollar throughout the period 1949-71, China has allowed its official exchange rate to depreciate against the US\$, basically because China has run persistent fiscal deficits which it has financed by credit creation through the State-owned banks. In the 1983-85 episode the balance of trade started to deteriorate in late 1984 and early 1985, at about the same time as inflation started to accelerate. Concerned by the deterioration in the balance of payments and the acceleration in inflation, the authorities imposed a credit squeeze starting in mid-1985 and import controls were imposed. (Soon afterwards, Hu Yao-bang was deposed.) The results were highly effective in slowing economic activity, reducing domestic demand and correcting the deterioration in the balance of trade. Partly as a means of restricting imports, and partly as a means to re-stimulate the export sector, China's currency, the Renminbi, was devalued in late 1985 and again in mid-1986, once domestic demand had slowed down.

The second episode of expansion got under way in late 1986 and culminated in the inflation of 1988-89, which in turn led up to the Tienanmen Square episode. During this expansion the reformists, led by Chinese Premier Zhao Zi-yang, undertook much wider measures of price liberalisation, and the first serious efforts were made to privatise property.

CHART 3: JAPAN 1954-72 TRADE, RESERVES AND EXCHANGE RATE

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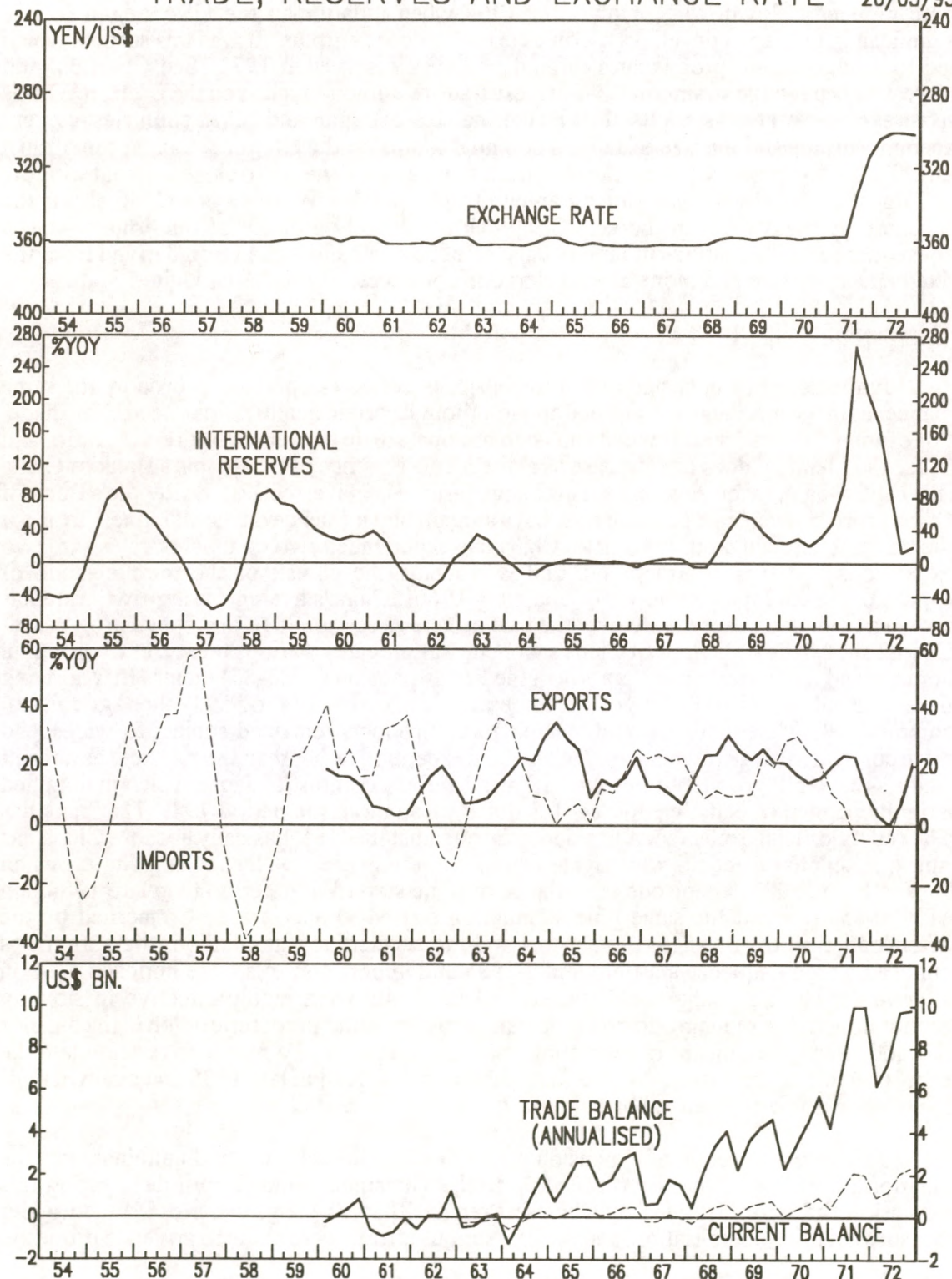
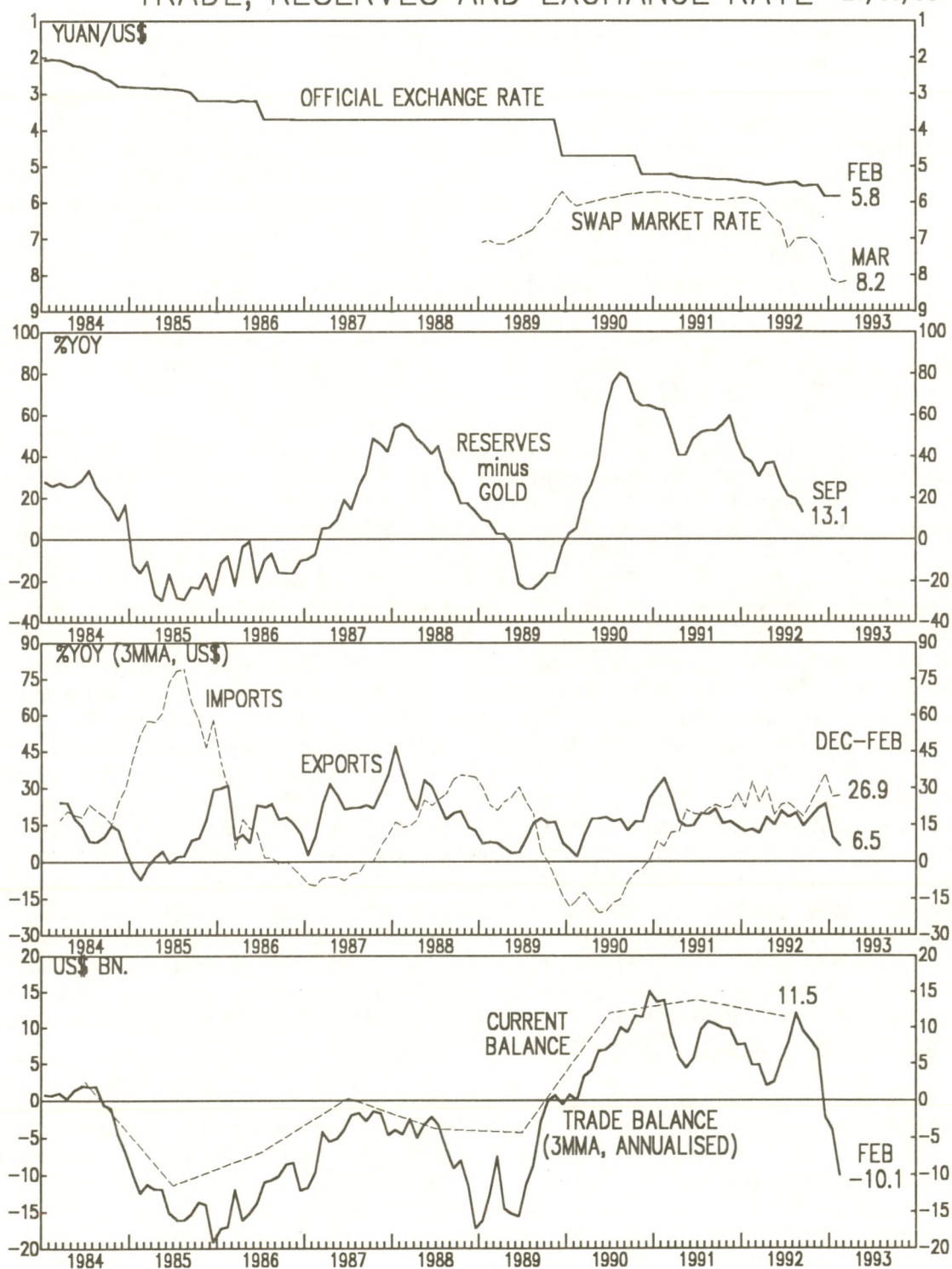


CHART 4: CHINA 1984-93 TRADE, RESERVES AND EXCHANGE RATE 26/03/93



Numerous manufactured goods prices and industrial raw material prices were freed up, experiments were conducted in the privatisation of housing, and security markets -- mainly for bonds -- after a lapse of 40 years. Monetary growth accelerated in 1986 and maintained a rate of close to 30% p.a. through 1987 and 1988, and real GNP and industrial output accelerated in tandem. Once again, the balance of trade began to deteriorate in mid-1988, as imports accelerated. From September 1988 a modest tightening of credit was initiated, and political pressure for the dismissal of Zhao Zi-yang began to grow. Inflation and social discontent became serious problems by April 1989, culminating in the Tienanmen Square demonstrations and the subsequent massacre. The balance of payments crisis was then exacerbated by the withdrawal of foreign lending to China in the wake of the Tienanmen Square massacre, requiring the People's Bank to step in and support the official exchange rate with sales of foreign exchange reserves. The credit curbs were greatly intensified from June 1989 onwards and, in addition, import controls were once again put in place. The economy responded in a predictable and orthodox manner, slowing abruptly, with the balance of trade improving sharply during the second half of 1989 as imports plunged, and trade surpluses emerged in early 1990. Foreign exchange reserves were rising again by early 1990, but nevertheless the Chinese authorities -- repeating the pattern of 1985-86 -- devalued the Renminbi in December 1989 and again in November 1990.

The current expansion has its origins in the dramatic improvement in the trade accounts and hence in the overall balance of payments in 1990, since the growth in foreign exchange reserves permitted the authorities to ease up on credit restraints from 1990. However, because the fiscal deficit has remained a persistent problem and has not been financed only by borrowing, monetary growth has been sourced from both foreign asset growth and domestic credit creation by the People's Bank of China. Broad money and credit growth have been permitted to proceed at close to 30% per annum for three years. In much the same way as the credit squeeze of 1985 gave way to the reformist phase under Zhao Zi-yang in 1987-88, so on this occasion the austerity programme of Premier Li Peng has given way to the pro-reform programme of the senior leader Deng Xiao-ping. In addition, on this occasion there has been a further liberalisation of industrial and raw material prices, and the rapid development of markets for equities in Shanghai and Shenzhen, as well as the promotion of a real estate market in a number of coastal and inland cities. The gross value of industrial production and real GNP have grown at even faster rates than in previous upswings, recording 24% and 12.8% respectively in 1992. The balance of trade is deteriorating sharply as import growth outpaces export growth (Chart 4). Moreover the level of foreign exchange reserves appears to have peaked in July 1992, and their growth rate is certainly heading towards negative territory. As a consequence of the three year monetary expansion, inflation in the cities has now reached 15.7% (Chart 2), while inflation at the national level has reached 10.5% year-on-year in January-February 1993. Consequently, it seems clear that inflation is heading upwards and China is therefore facing a third serious episode of overheating in the space of a decade, which will again require the imposition of monetary or credit controls, either in the second half of 1993 or in the first half of 1994.

There are many commentators, however, who argue that on this occasion the Chinese economy is significantly different from its condition in the 1980s and therefore inflation is not such a significant threat. Briefly, these commentators either assert that supply-side changes have been so great that growth in output and incomes will absorb the rapid monetary growth without inflationary consequences, or they argue that since the range of assets available to Chinese mainland residents has expanded enormously (i.e. securities, real estate and housing) the transmission process by which excess monetary growth will translate into inflation will

be much more prolonged and the end result may be lower CPI inflation than in conditions where there was no absorption of excess money growth by the asset markets. The validity of these arguments depends in part on the extent to which the fundamental behaviour of the Chinese business cycle will be modified by changes in China's institutional arrangements. To clarify the discussion we take four issues and examine their significance for the current business cycle.

Key Issues and their Impact on China's Business Cycle.

1. Interest Rates.

China's financial institutions (mainly state owned banks) do not use interest rates as a means of allocating credit. Historically, like Japanese banks in the 1950s and 1960s, they have allocated credit to state owned enterprises (SOEs) according to a national economic plan or a state credit plan. In other words China's lenders are bureaucrats, not bankers. In recent years economic liberalisation has widened the losses of many of the SOEs and as a result the banks have become cashiers to the state owned sector, in effect subsidising SOEs losses with new loans.

Under the pre-1978 regime all prices and wages were controlled, and only low nominal interest rates were charged to borrowers or offered to depositors. With the advent of economic reform, interest rates have been used more actively on the deposit side to attract funds (e.g. in the 1989-90 monetary squeeze deposit rates were raised to attract cash back into the banking system), but not on the lending side. Since interest rates are not used to choke off the demand for credit and credit is allocated very much in response to political pressure during episodes of economic expansion, credit expansion tends to be pro-cyclical. Only when inflation becomes a real problem or when there is a balance of payments crisis are the authorities compelled to impose credit restrictions. Normally, they combine these with other administrative controls such as import restrictions and the payment of part of wages in the form of IOUs or government bonds. Using the analogy of a motor car, western central banks use the accelerator and the foot brake to adjust the rate of monetary growth. In the Chinese case, the motor car does not have an accelerator or foot brake, only a hand brake, and sooner or later (in late 1993 or early 1994) China is going to have to apply the hand brake.

As China's financial markets develop from a state of financial repression, the controls on interest rates can be expected to be removed gradually, but this is a process which is going to take many years. Considering that countries like Japan or South Korea have not yet fully liberalised their financial markets, it would be expecting far too much for China to achieve the same degree of financial liberalisation within a few years. Consequently, China's business cycle will continue to be driven either by the balance of payments, or by state-determined credit creation, but not by the central bank managing interest rates to conform with a desired or planned rate of monetary or credit growth. As a result we should expect China's business cycle in the 1990s and in the 2000s to resemble a roller-coaster, with repeated and rather drastic episodes of STOP-GO just like Japan in the 1950s and 1960s.

2. Asset Markets.

The discussion of China's business cycle above explained how asset markets have been developing in recent years. However, it is still true to say that mainland Chinese individuals

and entities have very few ways to hedge themselves against inflation because China's asset markets are so under-developed. Consequently when concerns about inflation become widespread and velocity starts to accelerate, it is likely that there will be intense speculation in the limited range of asset markets which are available, i.e. real estate and equity markets, but much more likely that the population at large will attempt to hedge themselves by purchasing items such as TVs, bicycles and other durables. In addition -- and this is already happening -- China's residents are likely to use foreign currency as a means of hedging themselves against inflation. So far as inflation is concerned, the existence of limited asset markets is unlikely to change the profile of inflation very significantly. It may help to delay the transmission of inflation from money to consumer prices, but it will not significantly change the ultimate rise in consumer prices. The reason is that at any point in time firms and households face a portfolio choice amongst a given range of assets -- real (tangible) property including real estate and durables, securities, goods and services, foreign exchange and domestic money or currency. In aggregate the prices of these items will rise in some roughly fixed proportions to the increase in the quantity of money over the business cycle as a whole -- even if these proportions vary during interim stages of the business cycle.

3. *Exchange Controls and the Two-Tier Exchange Rate.*

China currently maintains extensive exchange controls both on current account transactions and on capital account transactions. During the Bretton Woods era Japan also maintained exchange controls, initially on both current and capital transactions, but later only on capital transactions, and the Japanese regularly tightened up capital outflows when movements of the balance of payments were adverse, and regularly eased up on capital controls when balance of payments developments were favourable. Since 1989 Chinese entities which exceed their foreign exchange earnings quota have been permitted to sell foreign exchange on the so-called swap market to other Chinese entities who are willing to pay the going price for foreign exchange. The main effect of the two-tier exchange rate in China today is to grant users of the official foreign exchange a privileged (cheap) price for foreign exchange, while penalising other users. The swap market does not have any implications for the business cycle, and will not have unless the People's Bank of China starts to intervene in this market, thus generating monetary expansions or contractions as a by-product of its interventions. (The People's Bank does influence the rate in the swap market through varying the allocations of foreign exchange quotas, but these changes in administrative rules do not necessarily affect the quantity of high-powered or base money.) Currently the central bank, i.e. the People's Bank of China, intervenes only in the official market maintaining a stable rate against the US\$. In recent years this rate has been allowed to depreciate modestly. Despite rumours of an impending devaluation, it is unlikely that the authorities would permit a significant devaluation while domestic demand is growing very strongly because this would simply transmit higher import prices rapidly to the domestic economy. Instead of continuing with a two-tier exchange rate policy the best short term solution for China would be to unify its various exchange rates (official, swap market, and black market rates), and for the central bank to intervene in the new unified exchange rate market. This would have two advantages. First, when there was a tendency for the Renminbi to depreciate, intervention by the central bank would withdraw Renminbi funds from the market and thus tighten up the supply of money in the domestic economy. Second, by unifying the various exchange rates China would achieve a uniform transmission of foreign prices into the domestic economy and end the discrimination against those who do not have access to the official rate for foreign exchange. In combination, these measures would help to modify the amplitude of fluctuations of monetary growth and hence China's business cycle,

while simultaneously improving economic efficiency in the domestic economy.

4. *Productivity Growth and Inflation in Traded versus Non-traded Goods Prices.*

Assuming China continues with economic reform the country is highly likely to experience very rapid growth of productivity over the next decade or two. Assuming also that China persists with a broadly fixed exchange rate policy vis-a-vis the US\$, this will mean that although traded goods prices will remain in line with traded goods prices in the USA, asset prices and non-traded goods prices should be expected to deviate very substantially from asset prices and non-traded goods prices in the USA. Hong Kong is experiencing exactly this kind of divergence of non-traded goods prices from non-traded goods prices in the USA at the present time. Japan too experienced exactly the same kind of divergence of non-traded goods prices from non-traded goods prices in the USA during the period 1949-1971. Over this period US consumer prices rose at an average of 2.4% p.a. while Japanese consumer prices rose at close to 5% p.a. (See Chart 1) -- virtually double the US rate. Experience has shown that asset prices such as land and buildings also tend to rise at least in line with nominal incomes and non-traded goods prices, so that China should experience significant increases in asset prices relative to the behaviour of asset prices in the USA. So far as the business cycle is concerned this divergence of asset prices and non-traded goods prices from the prices of comparable items in the USA has no significant impact, but it does have important consequences for the composition of the balance of payments. Like other prices such as traded goods prices or wages, asset prices and non-traded goods prices can be expected to fluctuate through the business cycle, but they will not either determine the shape of the business cycle or render China less competitive at the assumed fixed exchange rate.

1-4. Round-Up.

Depending on whether and to what extent China maintains foreign exchange controls, the composition of China's balance of payments could vary substantially. If, like Japan in the 1950s and 1960s, China maintains capital controls and restricts foreign ownership of Chinese domestic assets, then instead of running a current account deficit and financing it with private capital inflows, China is more likely to repeat the Japanese experience, i.e. with wide fluctuations of the current account between surpluses and deficits, largely offset by changes in the central banks' holdings of international reserves. Under this scenario interest rate liberalisation is likely to be much slower. For both reasons the business cycle is likely to fluctuate more widely. If, on the other hand, China follows the example of Hong Kong in the 1950s and 1960s, abolishing exchange control and allowing unrestricted foreign ownership of domestic assets, then it is likely to experience a current account deficit financed by capital inflows which are attracted by the high rates of return on investment in China. Under this scenario interest rate liberalisation is likely to come much more quickly. This would provide the Chinese with another tool to improve their management of the business cycle. While it is hard to prove, China's economic development would almost certainly be faster under the latter case than under the former.

CONCLUSION AND FORECAST: China's business cycles in the 1980s and 1990s bear many resemblances to Japan's business cycles in the 1950s and 1960s under Bretton Woods. While Japan was not such a centrally planned economy as China in the 1980s, China has shifted substantially towards freer markets for goods and services (less so for factors of

production such as capital goods or other assets). In addition there are many similarities between the two economies in the two respective periods with regard to the underdeveloped state of financial markets and instruments, the existence of extensive exchange controls, the rapid rates of productivity growth and hence real economic growth in both economies, and finally the general adherence to fixed exchange rates (at the official level in China; more generally in Japan.) As long as China maintains a fixed (official) exchange rate, wide fluctuations in its business cycle are virtually unavoidable as a consequence of the direct or indirect impact of changes in foreign exchange reserves on the rate of growth of money and credit, and hence on domestic spending. The ups and downs of this Chinese roller-coaster will be accentuated by:

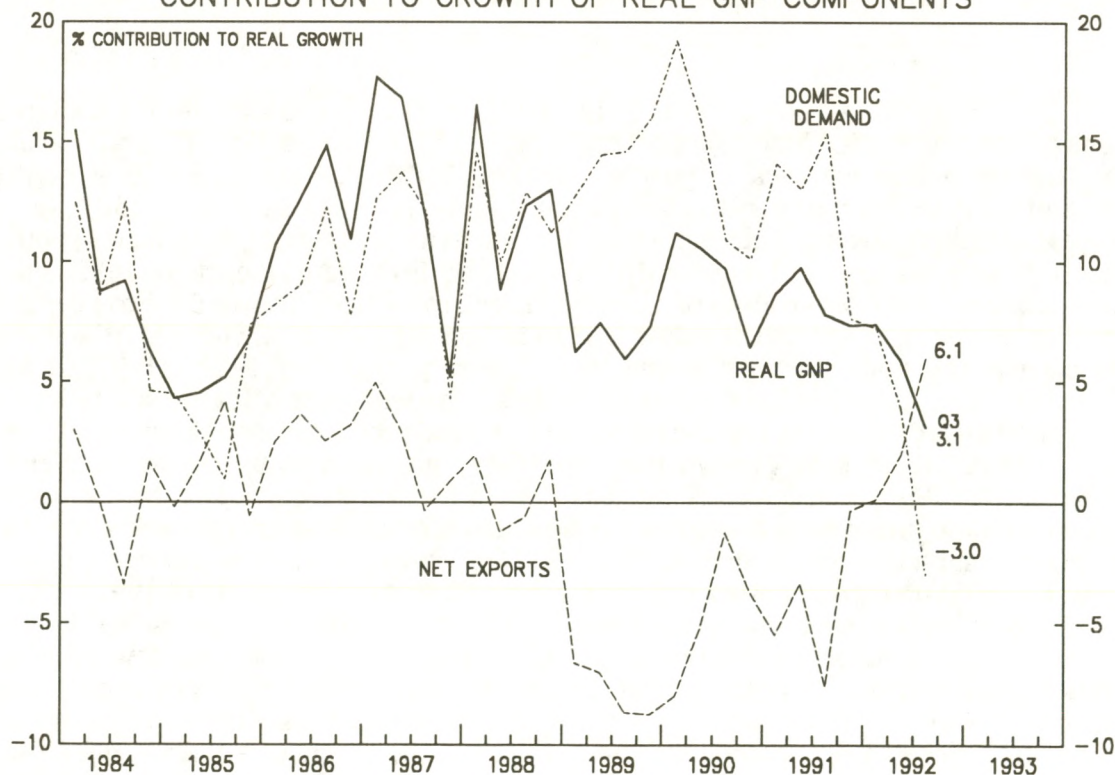
- (1) by the failure to use interest rates to choke off credit expansion or to encourage credit creation at the appropriate times,
- (2) by the tendency for the central bank to create credit, i.e. print money during the expansion phase to finance loss-making state-owned enterprises, and
- (3) the maintenance of foreign exchange controls -- especially on capital flows -- which will tend to force most of the adjustment on to the current account with the corresponding adjustment being in the central bank's stock of foreign exchange reserves (and hence money and credit growth), rather than being absorbed by changes in private sector capital flows and corresponding interest rate changes.

However, since China is in no position to move to a floating exchange rate system -- matched by sensitive control of domestic money and credit growth through the interest rate mechanism -- the economy faces the prospect of a series of STOP-GO-STOP episodes stretching through the 1990s and into the early decades of the next century. While the average real growth rate can be expected to be high, investors and traders should be prepared for considerable volatility about that average -- even in the absence of political shocks.

SOUTH KOREA ECONOMY NEARING BOTTOM, BUT WILL THE BIG BANG BE A WHIMPER?

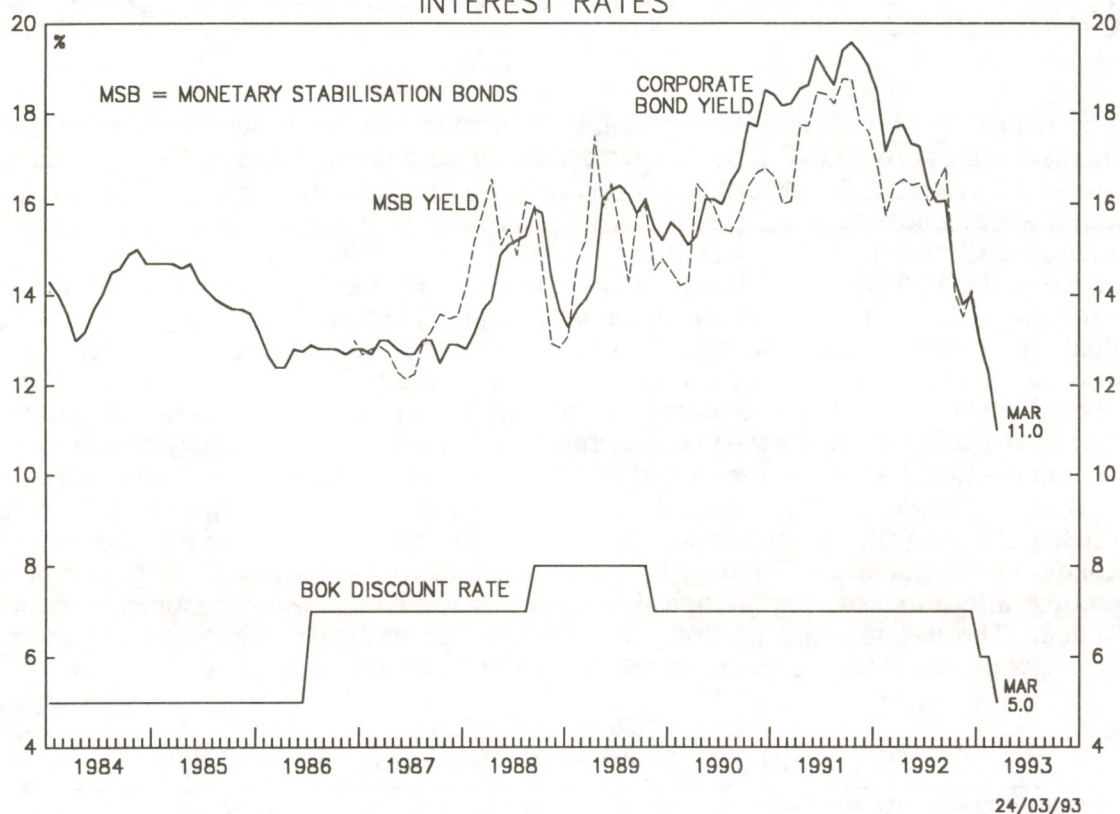
Korea, like Japan, is suffering from the hangover of a late 1980s capital expansion and asset price party. GNP growth slowed to 3.1% year-on-year during 1992 Q3 (Chart 1) -- an 11 year low -- and further still to 2.8% year-on-year during Q4. Share prices, despite a recent bounce, are still 30% below their peak, while property prices have already fallen 15-25% and could decline another 10-15% this year. However, one must not overdo the Korea-Japan analogy. The Korean authorities have readily acknowledged that the sharpness of the slowdown has caught them by surprise, and are now acting to rectify the situation. Interest rates have been pushed down precipitously towards historical lows (Chart 2), money growth targets have been raised, fiscal policy has been loosened with expenditures front-loaded, and perhaps most significantly, the anti-consumption rhetoric and moral suasion of the last year is being reversed. Korea remains a hugely concentrated economy -- Seoul accounts for around two-thirds of economic activity -- dominated by the chaebol (conglomerate) behemoths, and blessed (sic) with a tightly controlled financial system. As a result, the authorities have had the power to change the direction of the economy fairly rapidly. Certainly last year's slowdown owed as much to government resource allocation and psychological warfare, as it did to orthodox monetary policy conduct. The question remains, however, as to whether they can manipulate the economy back upward as sharply, or whether recovery will be elusive and slow.

S.KOREA: CHART 1
CONTRIBUTION TO GROWTH OF REAL GNP COMPONENTS



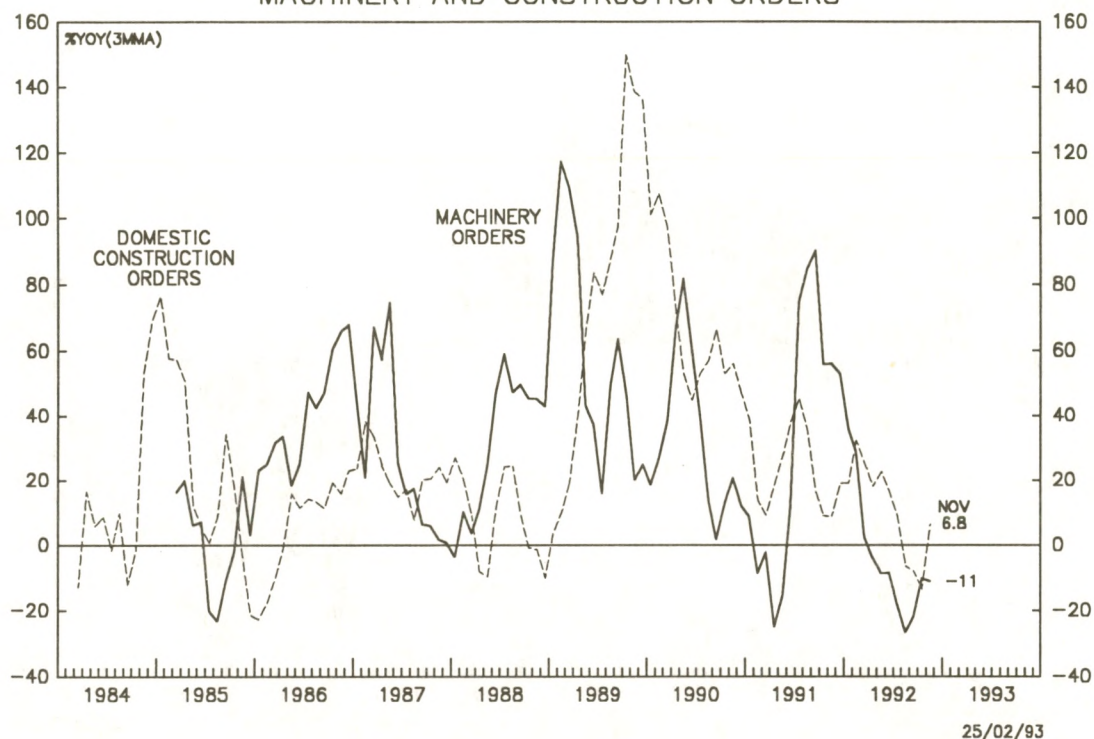
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S.KOREA: CHART 2
INTEREST RATES

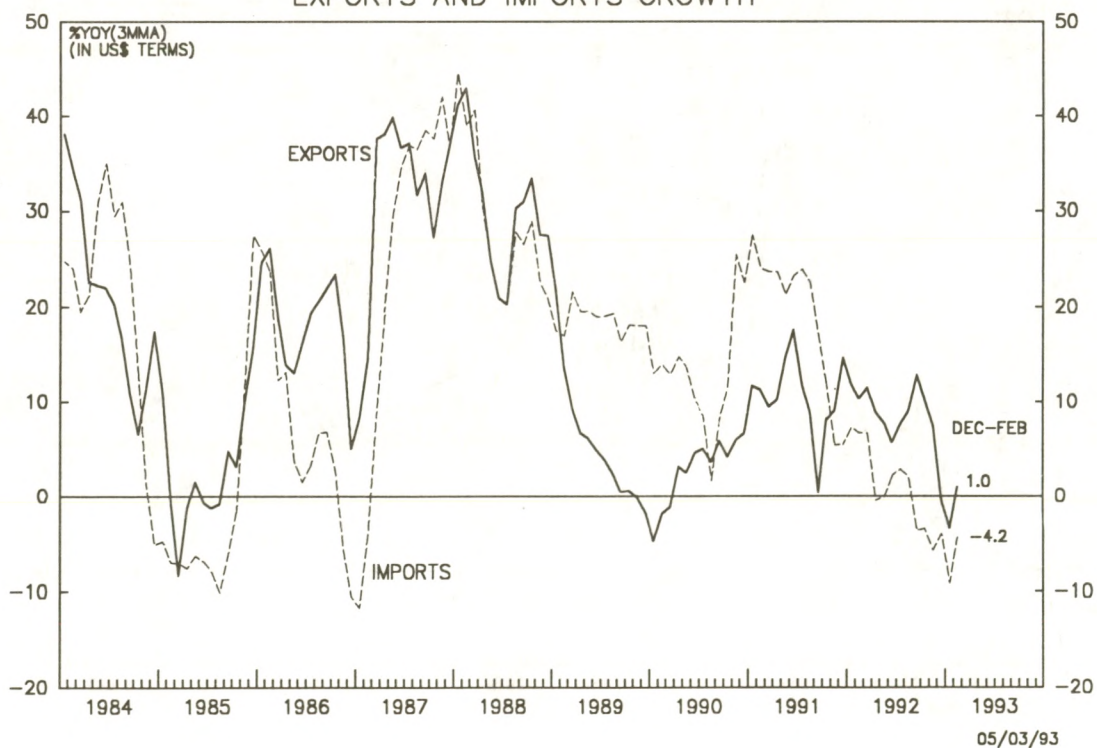


The economic data point to an economy that is still slowing, but exhibiting scattered signs of bottoming out. Machinery orders appear to have found a floor (Chart 3) while construction orders are back in positive territory. This reflects the decision of the government to start issuing construction permits again -- permits issued are up 150% year-on-year. Import growth is still negative but also seems to be troughing out (Chart 4) while export growth has remained reasonably strong. (The dip towards the end of 1992 is the consequence of the front-loading of orders at the end of 1991. This was done to keep the headline current account deficit below US\$10 billion for 1991 as a whole.) As a result the current and trade accounts swung back into surplus during 1992 Q4 (Chart 5). However, other indicators have yet to turn. Retail and wholesale sales are still pointing firmly downward (Chart 6), as is the growth of industrial production and shipments (Chart 7). Until recently, inventory growth remained fairly high, but in contrast to the experience of Japan over 1991, it never accelerated as Korean firms were quick to cut back stocks in line with the production slowdown. Indeed, the national accounts figures show that inventory contraction contributed -4.7% to 1992 Q3 growth -- i.e. the rest of the economy grew 7.8%. With capacity utilisation falling from 82% at the beginning of 1992 to 73% now, and exports expected to grow around 10% during 1993 in response to the US recovery, a rebound in production should come through over the next few months. Consumption may be slower to respond though. Negative wealth effects from declining property prices and the potential for rising unemployment as Korean firms try to rationalise, suggest a deceleration well into this year. The weight of evidence, therefore, points towards a gentle rebound in economic activity with inflation remaining subdued (Chart 8).

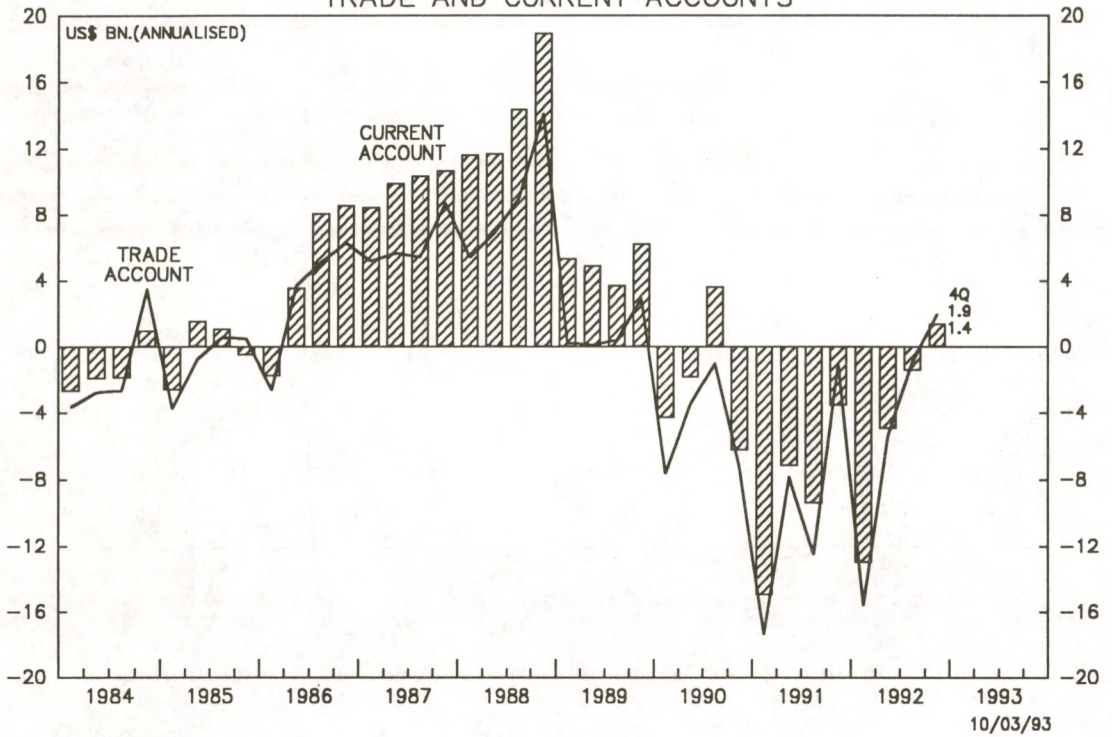
S.KOREA: CHART 3
MACHINERY AND CONSTRUCTION ORDERS



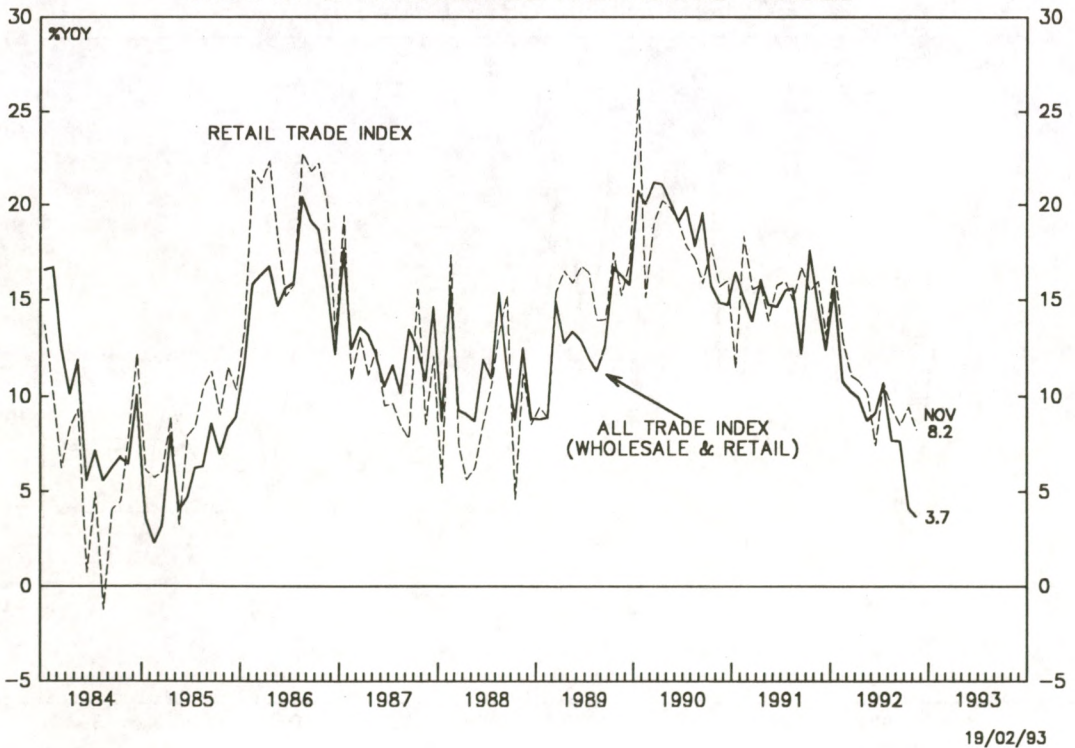
S.KOREA: CHART 4
EXPORTS AND IMPORTS GROWTH



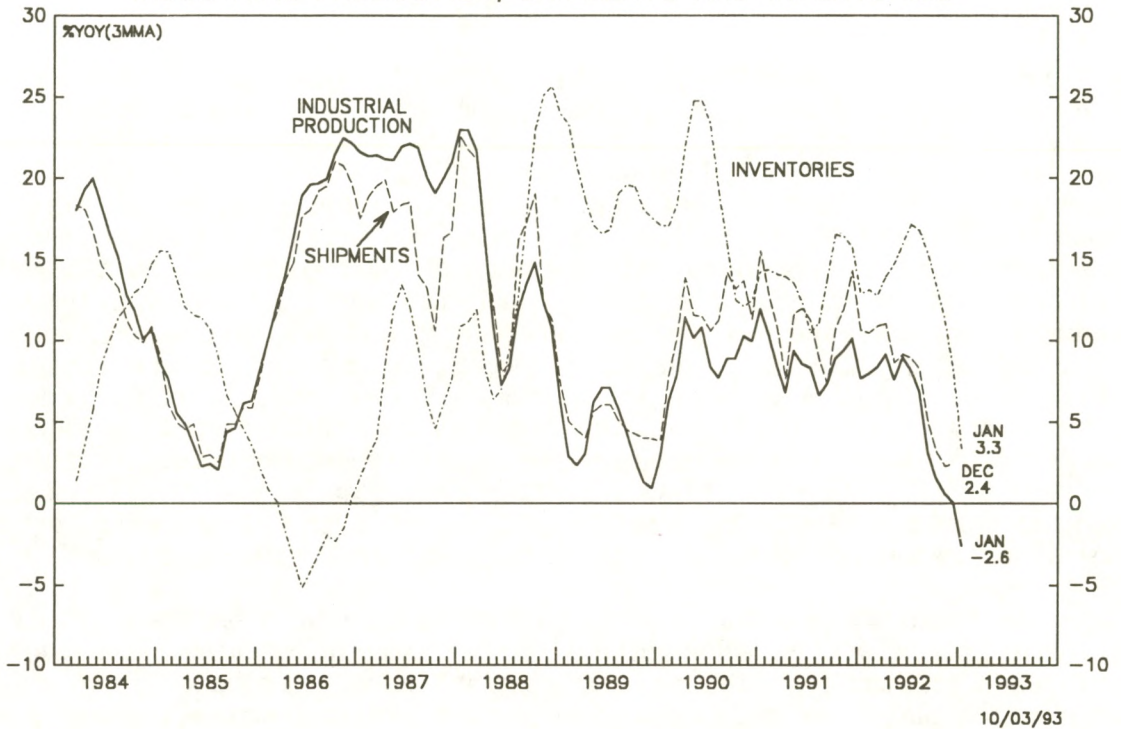
S.KOREA: CHART 5
TRADE AND CURRENT ACCOUNTS



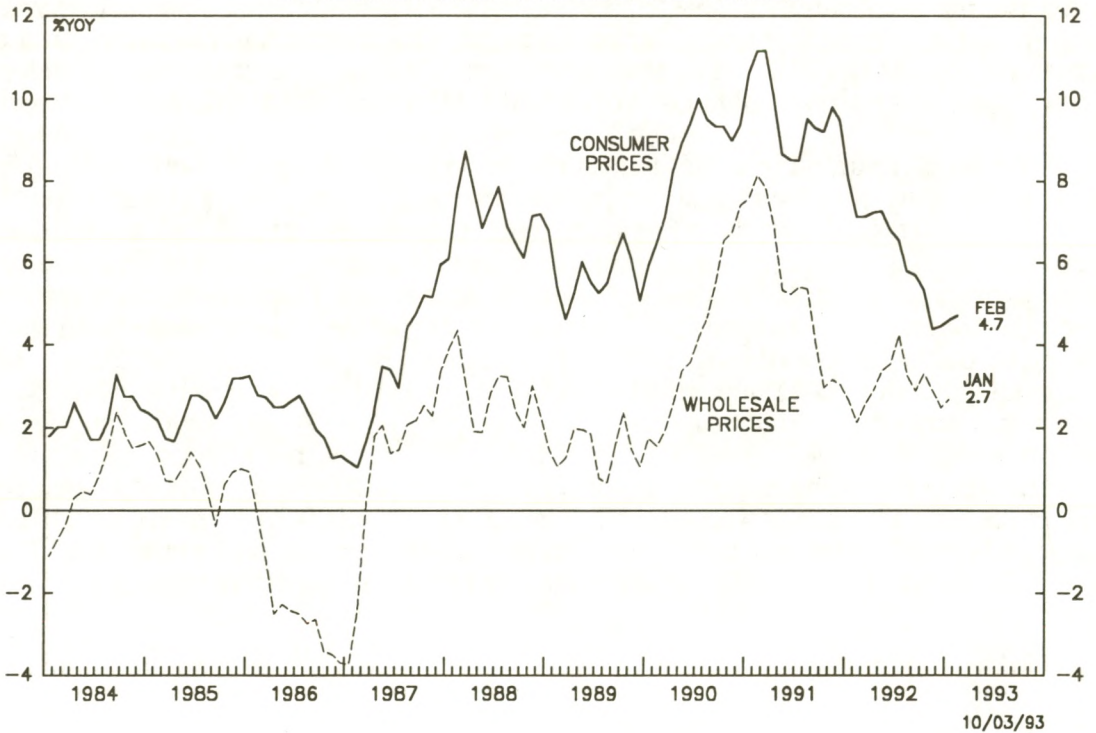
S.KOREA: CHART 6
GROWTH OF WHOLESALE AND RETAIL TRADES



S.KOREA: CHART 7
INDUSTRIAL PRODUCTION, SHIPMENTS AND INVENTORIES



S.KOREA: CHART 8
CONSUMER AND WHOLESALE PRICES



What of the monetary environment though? It has been mooted that the new administration of Kim Young Sam will speed up the pace of financial liberalisation, and finally implement the oft-postponed, second round of interest rate decontrols which would free almost all bank and financial institution lending and deposit rates. Originally tabled for mid-1992, this is the most important phase in a three-part plan to restructure Korea's financial system by 1997. On the face of it, it seems likely that Phase II will be enacted as Kim has a window of opportunity at the beginning of his term of office to push through legislation. Moreover, such a move would help to improve relations with the US administration. Korea and the US are currently engaged in various anti-dumping, market access and currency manipulation disputes. However, the freeing of interest rates per se, will do little to unshackle Korea's repressed financial system unless the credit allocation system is simultaneously dismantled. This would involve a curtailment of bureaucratic power to deploy scarce financial resources, and an end to guarantees of cheap, available credit to the chaebol. Given that Kim was the establishment candidate and that his election campaign was heavily funded by a number of chaebol, one is left with the feeling that the vested interests will be able to block any attempts to reform the allocation system.

This is unfortunate, because Korea's development is starting to become retarded by its archaic financial system. Allocated credit means that inefficient chaebol receive low-cost, guaranteed funding, while small companies and individuals have to fight over the small residual pie. While total credit and economic growth are booming, everyone gets richer and distortions become less apparent. However, clamp down on total credit and slow the economy, and certain sectors suffer disproportionately. There were 8-10,000 small company bankruptcies in Korea during 1992, many of which were sound, innovative enterprises that were simply unable to access sufficient working capital at realistic interest rates. It can be argued that many were overgeared -- the average debt to equity ratio of Korean companies is 270% -- but government subsidies and resource allocation helped push up sharply the already high costs of capital for those outside the favoured network.

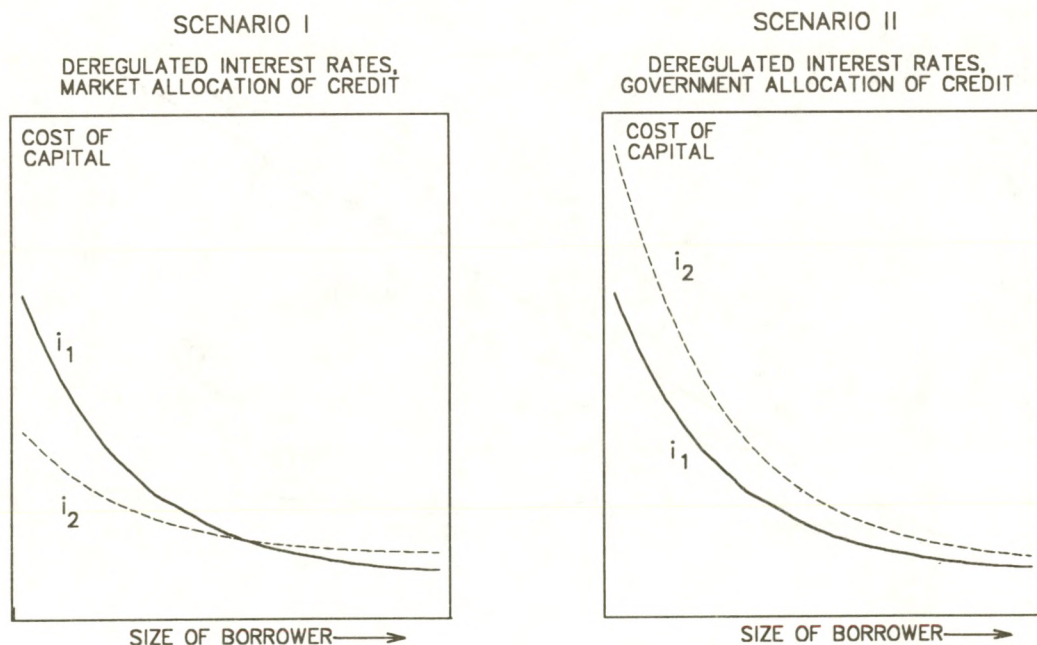
The structure of interest rates tends to be priced off the corporate bond yield. This rate is accessed by only the largest companies who can also borrow to a certain extent in the interbank market. However, a fair amount of borrowing can still be done at subsidised rates when a company operates in a "preferred" sector. Indeed, chaebol often move into these government-promoted businesses simply to access cheap capital and cross-fertilise their other operations. In sum, preferential, sub-corporate and corporate bond yield lending accounts for 40% of total credit. The remainder is split between corporate bond-plus lending (about 50%) and informal or kerb market lending (about 10%). Such financing is generally offered at the corporate bond yield plus 3%, although a complicated (and somewhat secretive) system of compensating balances pushes effective rates higher and varies them according to the creditworthiness of different borrowers. A compensating balance requires a borrower who wants funding of, say Won 100, to borrow Won 110 and redeposit Won 10, often in a low or non-interest bearing account with the lender. Thus the effective cost of capital will vary with the size of the compensating balance required.

This situation will tend to change radically, however, in times of a credit contraction. Preferred borrowers will get their funds, although at somewhat higher rates, but because the aim is to rein in total liquidity, corporate-bond plus lending will be curtailed leading to disproportionately higher interest rates, and more lending will be pushed into the informal markets. Thus when corporate bond yields reached 19% in mid-1991, korb market rates shot up to 30% or more. Subsequently, many companies were unable to pay these rates, or unable even to access credit at any price, and as the economy slowed and bankruptcies rose, so demand for, and the price of informal funds collapsed.

As indicated above, interest rate deregulation involving the freeing of most lending and deposit rates should be forthcoming this year but the dismantling of the credit allocation system remains highly unlikely. (Indeed, the Phase II blueprint explicitly excludes the freeing of rates on "policy loans" until sometime between 1994 and 1996.) As a result, the cost of capital for all but the largest of borrowers, could actually rise. Chart 9 illustrates why.

If interest rates were freed and the market allowed to allocate credit (Scenario I), then the interest rate curve would pivot (i_1 to i_2). The chaebol would have to compete for funds and financial institutions would be free to lend to whom they wished. The result would be a shift in resources away from various unprofitable, but "preferred" activities. However, if as is more likely credit allocation remains under the control of the bureaucrats (Scenario II), then given the non-preferred sector's structural lack of funds, its cost of capital would rise as lending rate caps are removed.

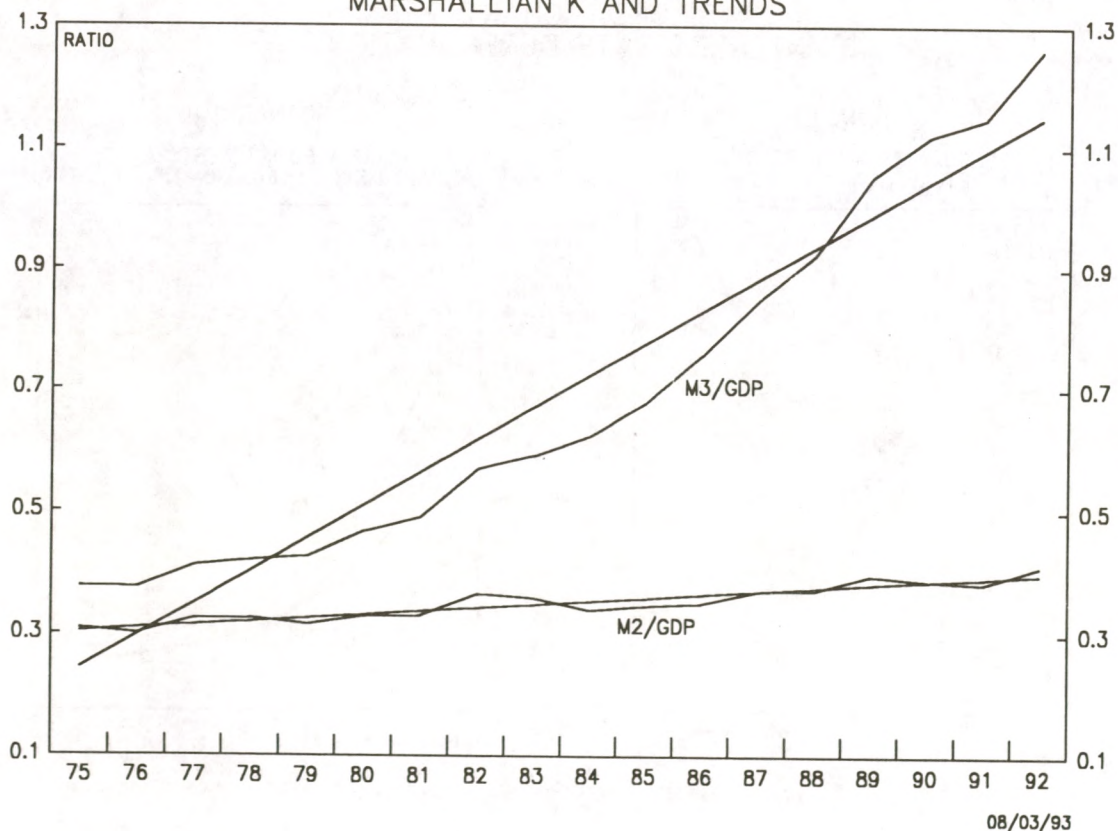
S.KOREA: CHART 9
INTEREST RATE DEREGULATION



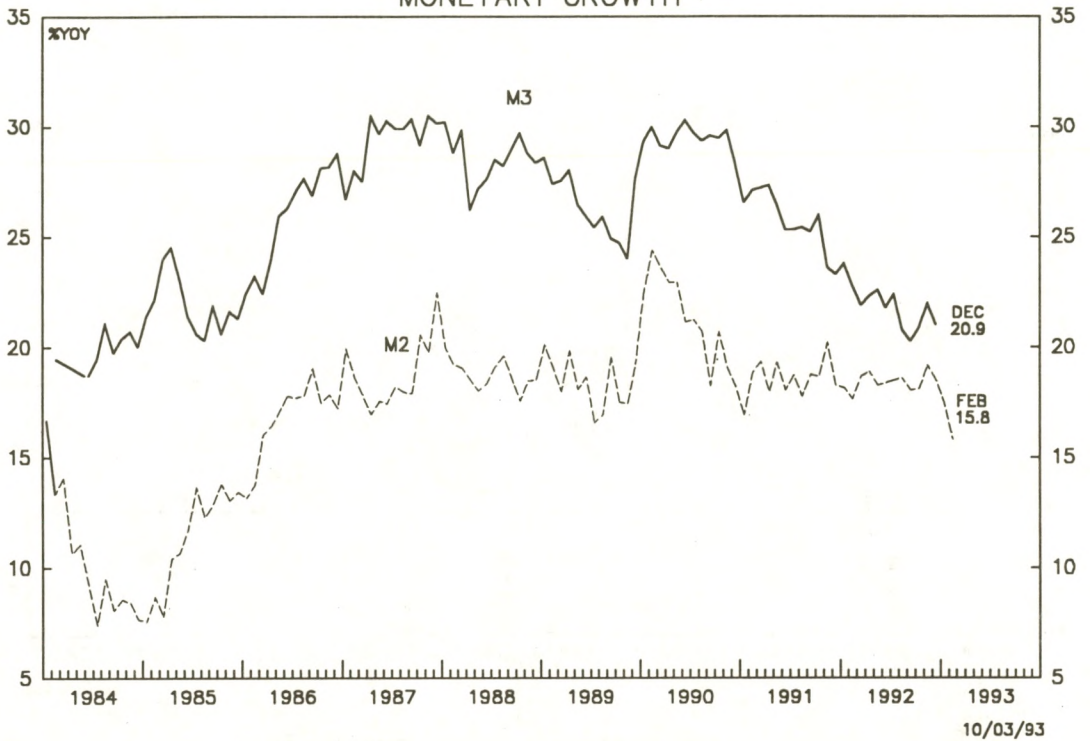
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The distorted structure of interest rates and the credit allocation process in part explains why economic activity collapsed while money remained readily available to certain sectors of the economy. However, government exhortations played an equally important role. Chart 10 shows Marshallian k based on M3 and M2. The ratio based on the Bank of Korea's (BOK) preferred measure, M2, has remained pretty stable over time reflecting the BOK's ability to closely control liquidity in the commercial banking system. However, the M3 ratio, remains well above trend as the lending of non-bank financials is regulated by the pro-growth Ministry of Finance. An argument can be made for recalculating the trend line starting in 1983, but this still suggests that liquidity has not been overly tight. Looking at trends in money (Charts 11 and 12), M2 growth has been pretty stable apart from a surge at the beginning of 1990 associated with failed stockmarket support measures. M3, however, which is almost three times the size of M2, has been decelerating from growth rates of 30% over 1990 towards 20% currently, due to the disproportionate rise in the cost of non-bank funds. Nevertheless, because both real GDP and inflation have collapsed to 4-5% during 1992, real M3 growth has been stable and velocity has plunged by over 10%. This in turn implies delayed expenditures as a result of moral suasion as opposed to a squeeze on real purchasing power. Such expenditures could therefore be supported by underlying liquidity should business and consumer confidence be restored. This proposition is supported by the growth of manufacturing wages and earnings which continue to outstrip productivity growth (Chart 13). The government's target for 1993 is 3-5% but this target is uniformly breached and most commentators expect wages growth to fall to 8-10% during 1993 at best.

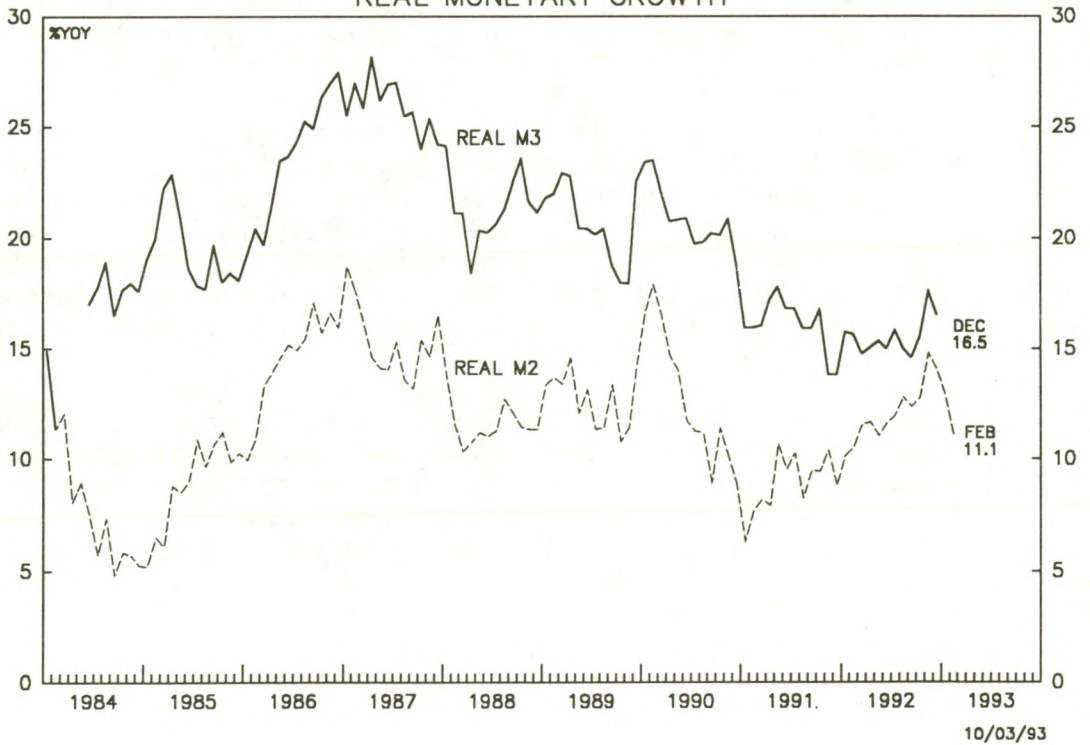
S.KOREA: CHART 10
MARSHALLIAN K AND TRENDS



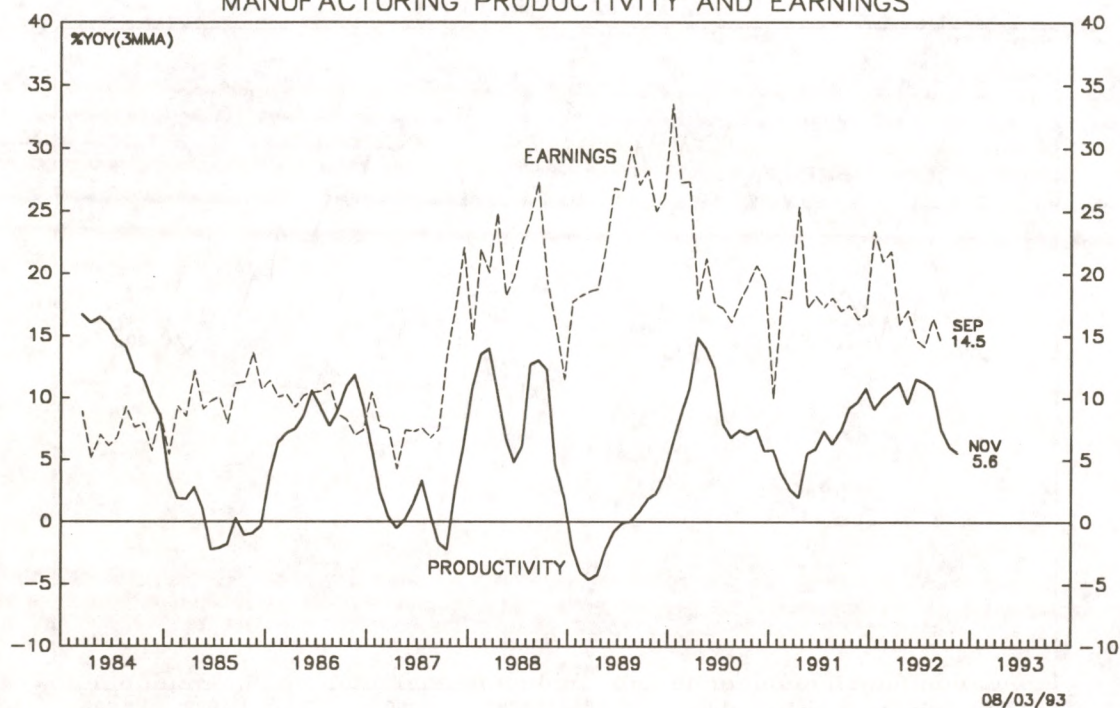
S.KOREA: CHART 11
MONETARY GROWTH



S.KOREA: CHART 12
REAL MONETARY GROWTH



S.KOREA: CHART 13
MANUFACTURING PRODUCTIVITY AND EARNINGS



The liquidity overhang argument is subscribed to by the BOK, but for the moment the emphasis of policy is on the need of the new administration to pump prime the economy. There is no doubt that the Koreans need to reverse the prevailing negative sentiment, but they must also be careful not to overstimulate or inflation could start to rise again. This in turn would further erode Korean company competitiveness and post-interest cost margins.

SUMMARY AND CONCLUSION: The Korean government is now doing everything in its power to halt the economy's rapid decline. The production cycle appears to be bottoming while consumer demand could continue to slow for a few quarters more, suggesting a mild overall rebound during 1993. Sentiment could also be boosted (temporarily) by the enactment of Phase II of Korea's interest rate deregulation programme which would free most lending and deposit rates. However, if as expected, the credit allocation system remains untouched, the cost of capital for all but the largest firms could actually rise.

Nevertheless, inflationary expectations clearly remain in the Korean economy despite the slowdown in activity over 1992. Wage growth remains too high relative to productivity and the liquidity overhang could fuel another round of price rises. This is unlikely to be a concern during 1993 and Korean companies should continue to enjoy the benefits of lower refinancing costs. However, their underlying margins continue to be squeezed and interest rates could start to rise again once the deregulation package is implemented. More so if economic activity is starting to reaccelerate. The bureaucrats and the chaebol understandably want to preserve their exalted status, but by doing so they are becoming an ever-increasing drag on the economy. Korea can still continue to enjoy high rates of economic growth without significant reform, but its full potential will remain untapped.

TAIWAN

A GENTLE MONETARY SLOWDOWN IN PROSPECT

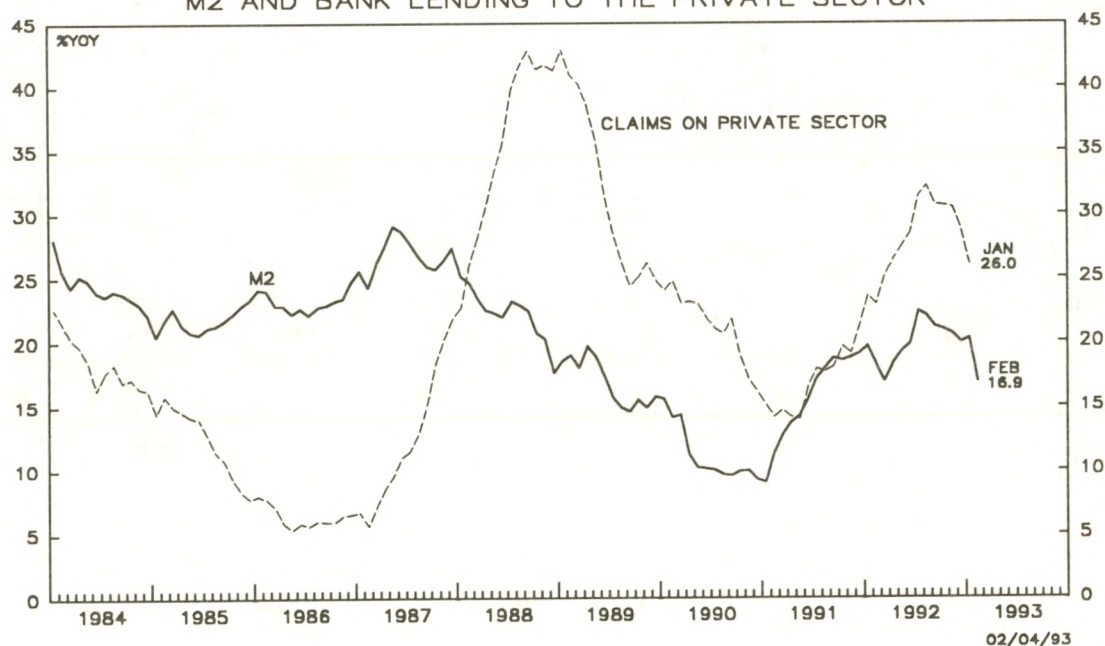
Introduction

Since 1990 broad money growth has been on an upward swing which seems to have passed a maximum of about 22% yoy in mid-1992. During this monetary upswing interest rates have been lowered by about 2%. Taiwan is now approaching the start of the downward part of the monetary cycle, where broad money growth will fall and interest rates may rise. However as will be discussed later, there are reasons to believe that this monetary downturn may not be quick and sudden (Charts 1 and 2).

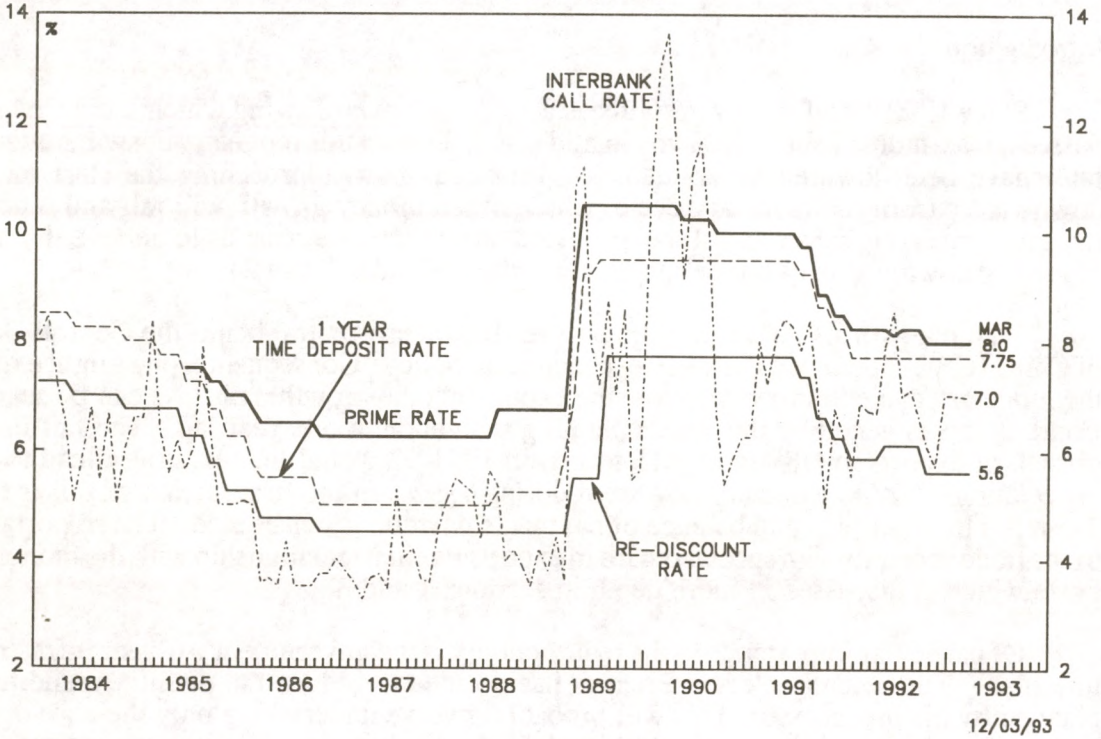
Like many of its Asian neighbours, the Taiwanese central bank, the Central Bank of China (CBC) operates a managed exchange rate policy. Consequently one might expect the monetary cycle to broadly follow the export/income growth path. As can be seen in Chart 3, this is generally the case, operating with about a one year lag. The fall in the growth of exports in US\$ (and NT\$ terms) in 1991-92 would then naturally lead to the expectation of some monetary downturn during 1993. In the first section of this article Taiwan's trade surplus and balance of payments position is considered. The importance of the trade accounts with special regard to exports lies in its relationship with the monetary cycle which is discussed in more depth in sections 1 and 3.

Of particular importance to the real economy is the government's 6-year infrastructure plan. The recently elected Premier has decided to reduce the public expenditures planned by his predecessor. This will probably involve undertaking only the core of the transport projects and those others with relatively quick returns. The major indicator of his view of the plan is given by his projected budget deficit for 1993, of NT\$250 bn. The implications of this for the deficit funding arrangements are explained in more detail in the second section of this article.

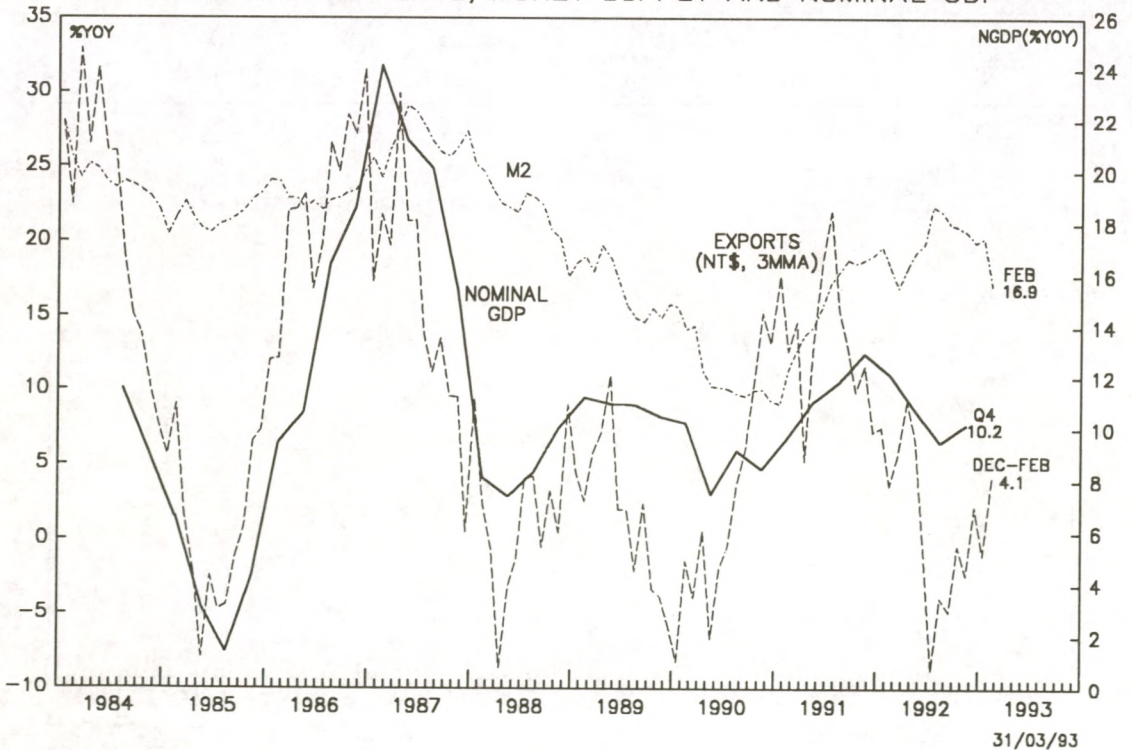
TAIWAN: CHART 1
M2 AND BANK LENDING TO THE PRIVATE SECTOR



TAIWAN: CHART 2
INTEREST RATES



TAIWAN: CHART 3
GROWTH OF EXPORTS, MONEY SUPPLY AND NOMINAL GDP



(1) The External Balances

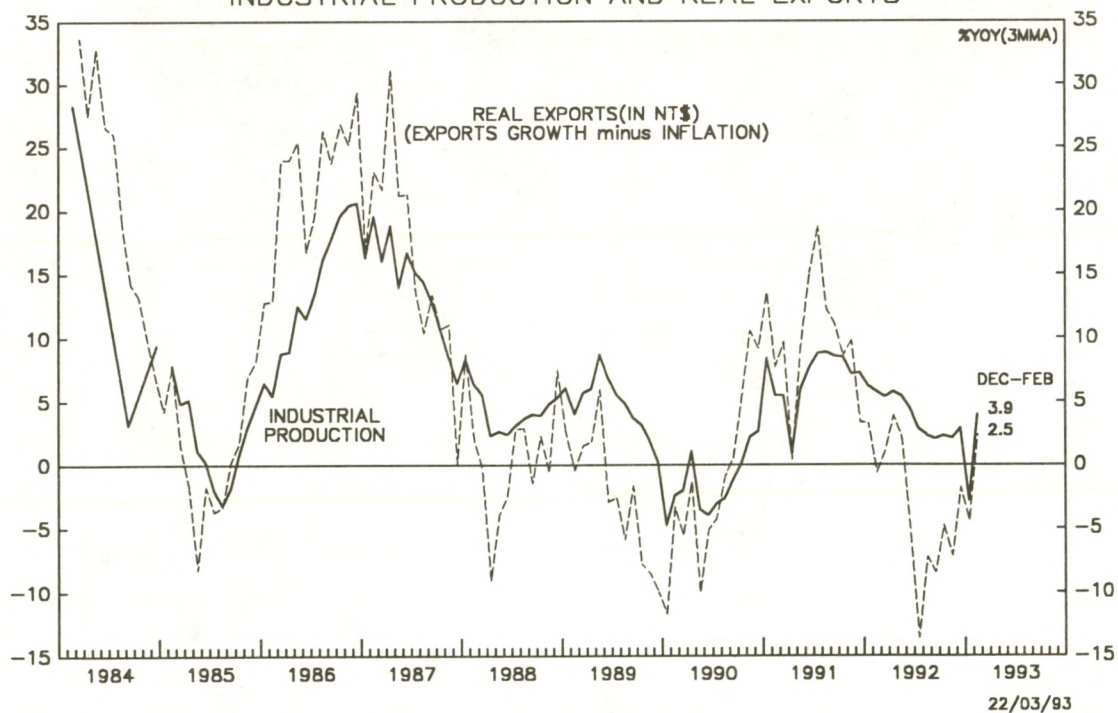
In this section Taiwan's trade account surplus will be discussed first followed by a comment on the overall balance of payments position.

Exports are an important aspect of Taiwan's industrial base contributing 60% to GDP. The significance of real exports to industrial production can be seen in Chart 4. When a slowdown in the demand for Taiwanese exports occurs, as is currently the case, the economy finds itself with excess capacity and its nominal income (GDP) growth would be expected to slow (Chart 3).

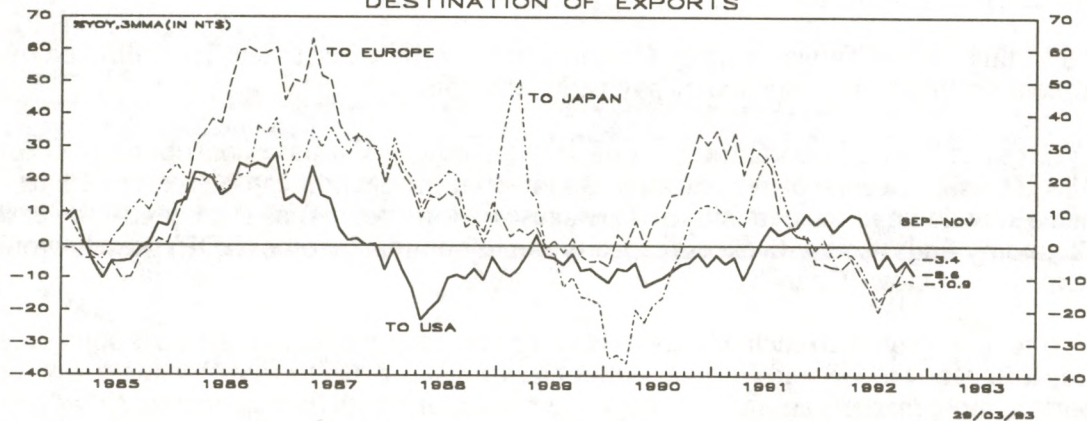
If export growth to each of Taiwan's traditional major foreign markets is considered -- i.e. to Japan, the US and Europe -- it comes as no surprise to find that the growth of exports to these markets has fallen to negative rates in line with their economic slowdowns (Charts 5 and 6).

A recent development in Taiwan's export markets involves a rise in the share of exports to Asia excluding Japan. This share is currently around 30%, of which about two thirds (or 19% of the whole "export pie") is destined for China. Those which go to China use Hong Kong as a stepping stone because of the politically induced trade and investment restrictions which still exist between Taiwan and China. Many of the exports to Asia are capital goods, which will be used to produce goods for foreign markets, for example: textile, plastic and rubber processing machinery. Whilst the growth rates of Taiwan's exports to its traditional markets were negative at the end of 1992, the buoyancy of Asian demand for Taiwan's goods has enabled overall export growth to register low though positive growth (in US\$ terms) (Chart 7).

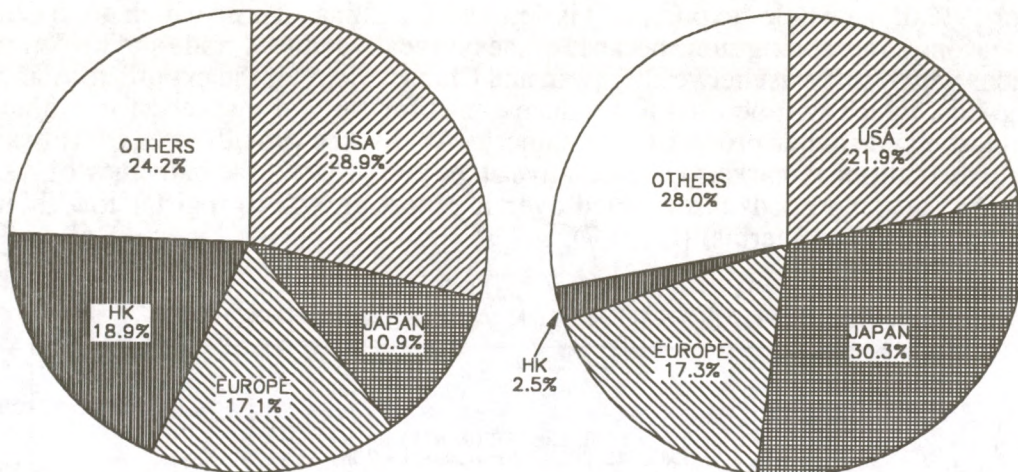
TAIWAN: CHART 4
INDUSTRIAL PRODUCTION AND REAL EXPORTS



TAIWAN: CHART 5
DESTINATION OF EXPORTS



TAIWAN: CHART 6
COMPONENT SHARES OF EXPORTS AND IMPORTS (1992)

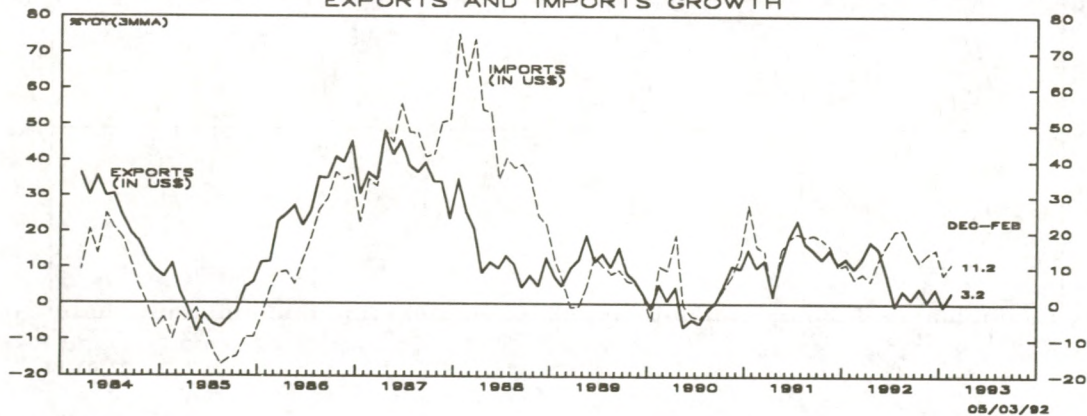


EXPORTS = US\$81.5 BN.

IMPORTS = US\$72.0 BN.

TAIWAN: CHART 7
EXPORTS AND IMPORTS GROWTH

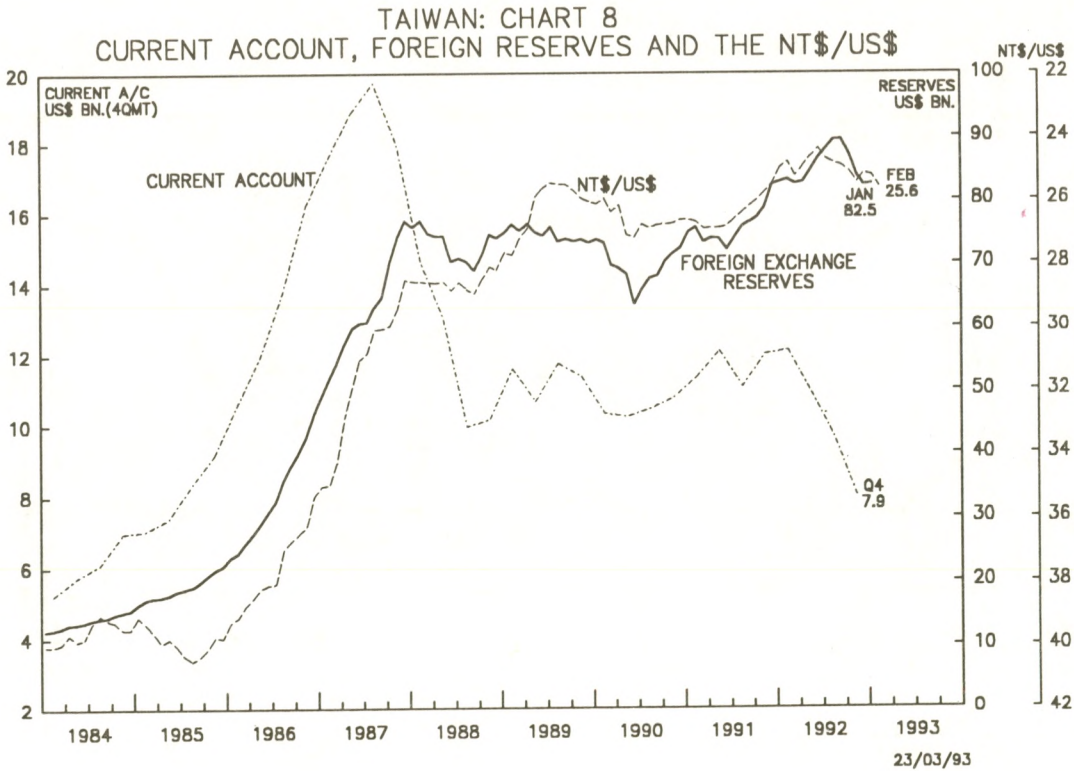
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Taiwan's trade surplus fell from US\$12 bn in 1991 to US\$7.9 bn in 1992 as a result of a higher import growth rate relative to export growth. One of the factors behind the stronger import demand was, and will continue to be, the capital equipment needed for infrastructure-related investment. Another factor recently affecting the imports figures is Taiwan's purchases of military hardware. This weapons purchasing programme is set to continue into 1993 and will keep import demand buoyant. For the reasons given above imports are expected to continue to grow at around 11-12%. A significant pick up in export growth in the second half of 1993 would be the indicator signalling that Taiwan may begin to see higher nominal income and broad money growth.

In addition to the fall in the trade surplus, the capital account deficit of the balance of payments has increased from US\$4.6 bn to US\$8.5 bn. The long term capital outflow component has been fairly stable over the last few years at around US\$3-4 bn, mainly reflecting Taiwanese investment in South East Asian countries where wage levels are lower. This is indicative of a long term change in the components of Taiwanese trade. Higher technology exports are becoming a more important sector as the lower technology manufacturing sector shifts to cheaper locations.

Taken together, the capital and current accounts gave rise to a fall in foreign exchange reserves over the latter part of 1992. However, foreign exchange reserves fell slightly further than this because of the CBC's policy of supporting the NT\$/US\$, which was in danger of depreciating further (Chart 8). A continuation of the deterioration in the trade account surplus could bring forth further support for the NT\$/US\$ if the capital account deficit maintains its present stance over 1993. The monetary implications of this are discussed in section 3.



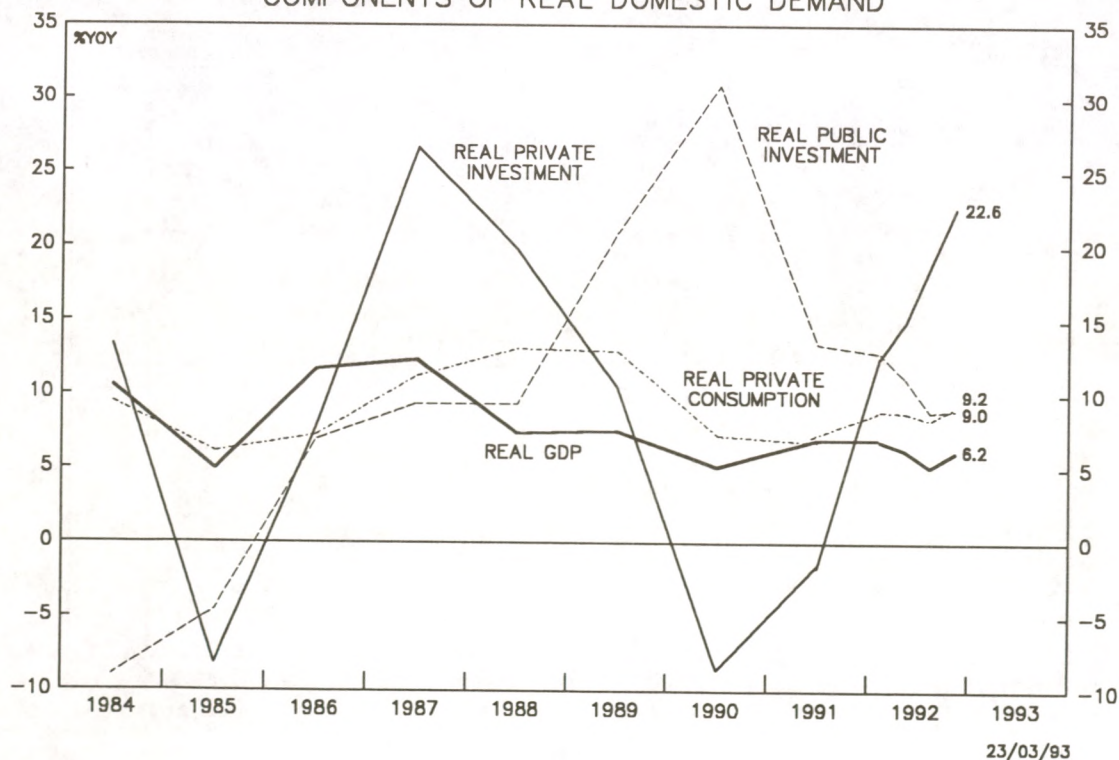
(2) Domestic Demand and the Government Sector

In the recent monetary upturn over 1991-92, Taiwanese real private investment growth (about 10% of GNP) has accelerated to 22.6% yoy. Some of this earlier investment was probably a response to the rise in export growth which immediately preceded the monetary upswing. However, some of it, especially in late 1992, was related to the government's infrastructure development plan, as can be seen by looking at its major components.

The significant components of real private investment growth are the machinery and transportation sectors. Their growth accelerated to 22.9% and 45.6% in 1992 from 3.7% and 17.7% respectively in 1991. In 1992, private construction investment also accelerated to about 5% from -0.4% a year earlier. This contrasts with construction investment in the public sector (accounting for 82% of total public investment) which accelerated to 22.2% in annual real growth terms over 1992.

In 1991 the government decided to raise public investment (also equal to about 10% of GNP) by planning a set of infrastructure development projects in the areas of transport, communications, urban housing and energy development amongst others. For a more detailed breakdown see AMM Vol. 16 No. 5. Until 1992 progress on this infrastructure plan had been slow, bogged down by difficulties in land acquisition and lack of political support. As a result the realised investments so far have not met the government's expectations and public investment growth has decelerated from 14% during 1991 to 9% during 1992 (Chart 9).

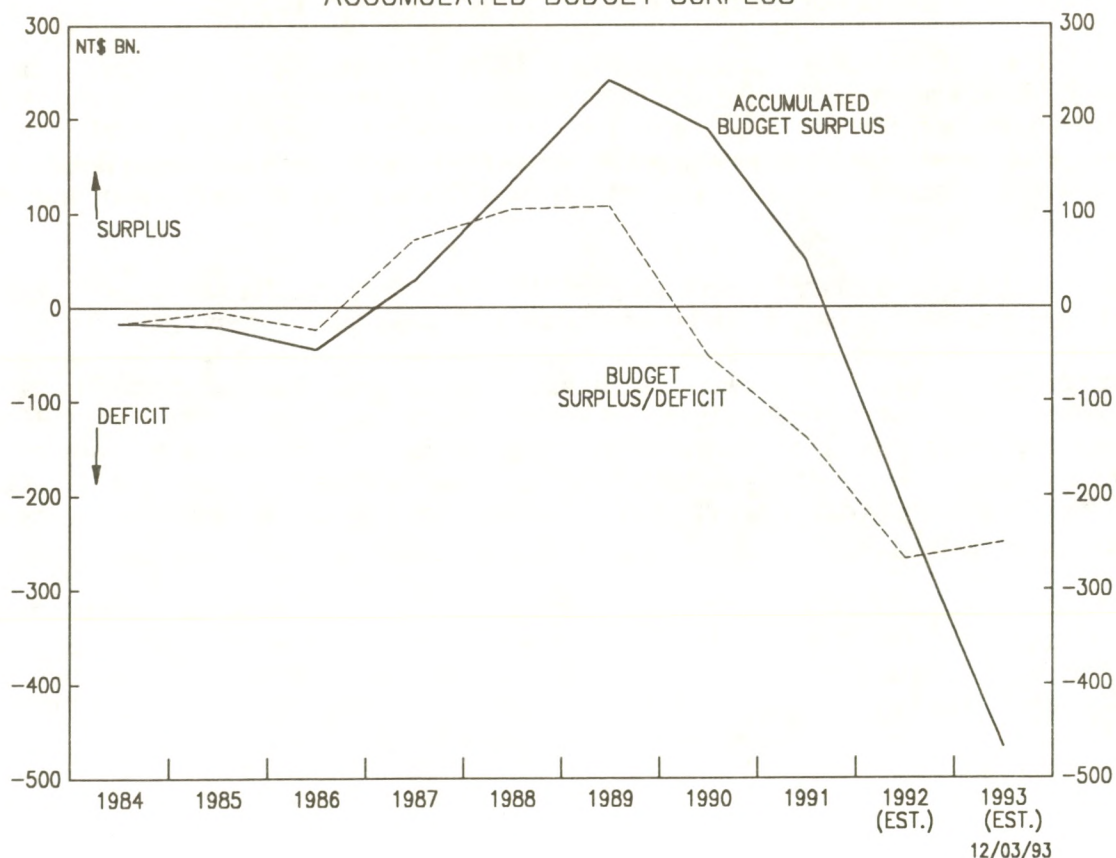
TAIWAN: CHART 9
COMPONENTS OF REAL DOMESTIC DEMAND



Despite planned public investments not being fully realised, the government has incurred a number of deficits over the last couple of years and has run down its accumulated fiscal surplus. For the fiscal year, which ends in July, the Central Budget Deficit is expected to be NT\$267 bn, or about 5 % of GNP. In 1993-94 the government plans to run up a NT\$250 bn deficit (Chart 10). Like last year this deficit will be bond funded. The deficit financing bonds are between 5-7 years in maturity offering rates between 8 and 8.5 %, all sold to the private sector. There has been little evidence of this public borrowing "crowding out" private borrowing and raising interbank interest rates, because of the CBC's open market repurchases of debt instruments.

One effect of the recent deceleration in export growth would be a fall in export-related lending for private investment. The beginnings of this can be observed in the fall in the growth of banks' claims on the private sector (Chart 1). Total real private investment growth will also likely fall over 1993 therefore, although its absolute growth rate should remain reasonably buoyant. As a result the contribution of public expenditures to domestic income growth may rise over the year. Whilst the external sector is expected to remain in the doldrums and contribute less to real GDP growth in 1993, the domestic sector will remain strong. Although lower export-related loan growth in 1993 is expected, some of this will be replaced with domestically driven loan growth as a result of the ongoing public investment. Growth in real GDP may exhibit only a modest decline as a result of these factors.

TAIWAN: CHART 10
ACCUMULATED BUDGET SURPLUS



(3) The Monetary Cycle

As briefly indicated in the introduction, broad money growth should continue to decelerate throughout most of 1993. Consideration of this in more depth requires examination of the following factors: the current and future patterns in export growth, changes in the current stock of foreign exchange reserves, and domestic demand. The first factor, export growth, can be seen as a leading indicator of the monetary cycle (Chart 3). When export growth does start to accelerate significantly later in 1993, although industrial production will respond relatively quickly, it may take between 6 months to a year before the rate of broad money growth responds in kind. Given the deceleration in export growth which started mid-1992, the broad monetary response would be similarly delayed.

In considering the previous upswing in monetary growth, there is a separate effect which would have served to raise M2 and private loan growth over 1991-92. This is the introduction of 15 newly capitalised banks in 1991. As they sought to expand their loan assets and gain market share the rate of growth of deposit creation would have risen. This has shown up both in higher broader money growth and in higher growth of claims on the private sector. However, this phenomenon had exhausted itself by the middle of 1992.

Another factor to consider when plotting the future path of M2 is the growth of the monetary base. This is where CBC monetary policy becomes relevant and where a finer brush is needed. Examination of the current balance of payments position shows a decline in foreign exchange reserves in 1992 by around NT\$640 mn. This fall is partly indicative of worsening current and trade accounts. However, it is not significant when compared with the total quantity of foreign exchange reserves, around NT\$82 bn.

The CBC currently operates a managed exchange rate policy and has been holding the NT\$/US\$ at around 26:1 over recent months. It is expected to continue with this policy. Support for this level can be found by considering Taiwan's tradeable goods competitiveness. On a purchasing power parity (PPP) basis using wholesale prices the NT\$/US\$ appears fairly valued. This indicates that Taiwan's exports are competitive even though their growth is slack.

As the trade balance has declined over 1992, contributing to further falls in foreign exchange reserves (Chart 8), the maintenance of this exchange rate policy could have brought about a potential tightening in the availability of interbank NT\$ deposits and higher interbank rates as a result. The reduction in the foreign asset component of the monetary base would have served to reduce its growth, were it not for CBC's countervailing action. This took the form of repurchasing debt instruments in the domestic money market. As previously indicated this fresh interbank lending also enables the new government issues of deficit financing bonds to be absorbed by the banking system without raising interbank rates.

As a result of these open market operations the monetary base has not exhibited slower growth. The longer that the CBC will be able to continue with this policy, the less likely that M2 will slow down further later on in 1993 from a deteriorating balance of payments. The large quantity of debt instruments outstanding suggests that the CBC is able to continue with these open market operations for some time to come.

The final indicator of future M2 growth may be found by considering domestic demand. As previously discussed the buoyancy in domestic demand will to some extent replace the fall in external demand over 1993. Whilst the rate of private loans growth is expected to fall later this year, its decline would be a gentle one given this domestic backdrop.

SUMMARY AND FORECAST: The new Premier, elected at the start of 1993, appears to be concerned with implementing a more curtailed version of the infrastructure plan than his predecessor. However, the current proposed 1993-94 deficit is not much different from that in the previous year and this will help keep domestic demand strong whilst the export sector is depressed. The current managed exchange rate policy will determine how monetary growth will change. The CBC is expected to continue to pursue its current support of the NT\$/US\$ and open market operations. Although the continued deterioration in trade surplus could eventually require the CBC to use higher rates of interest to support the currency, such action is unlikely unless reserve depletion accelerates significantly. It is only in the second half of 1993, possibly towards the end, that export growth and nominal GDP growth are expected to accelerate and thus induce a monetary upturn. Infrastructure based earnings would therefore be expected to continue to show signs of strength well before those in the export sector.

HONG KONG'S BUDGET DEFICIT AND INFLATION

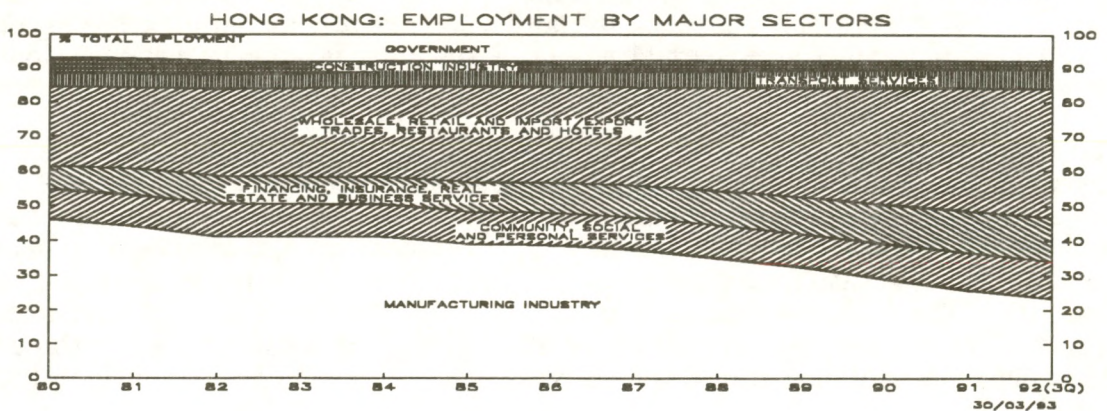
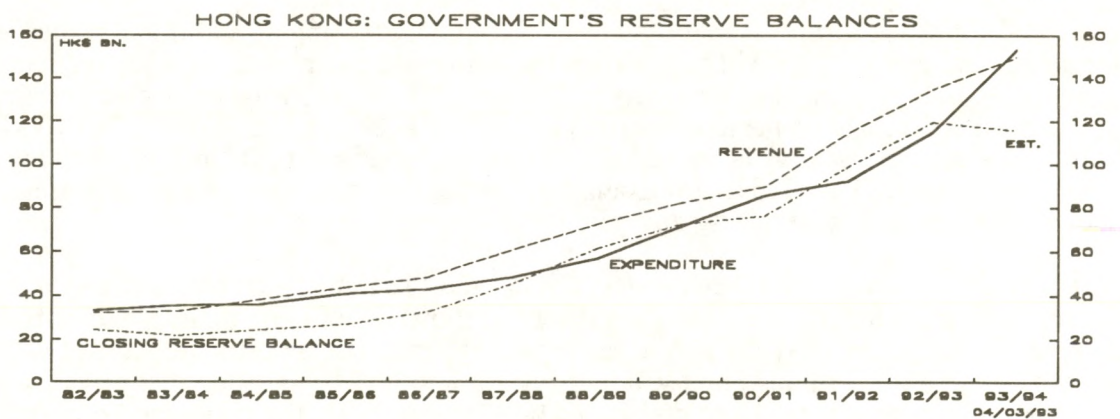
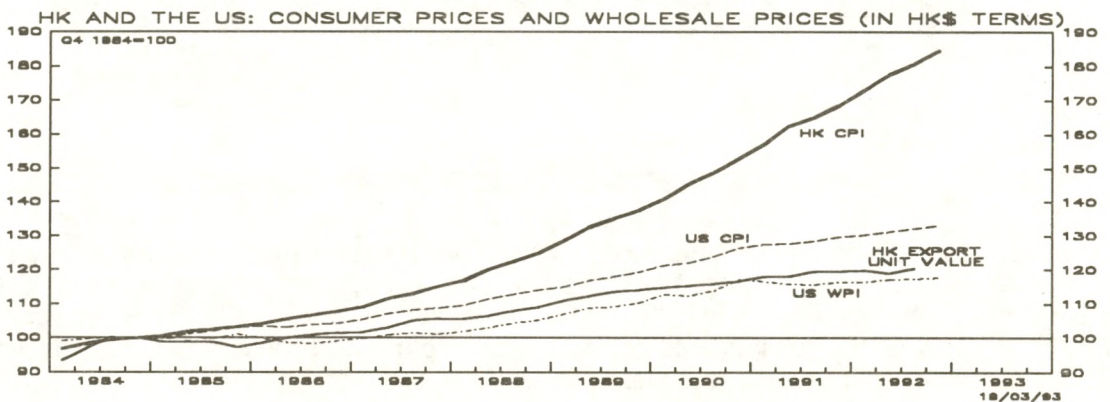
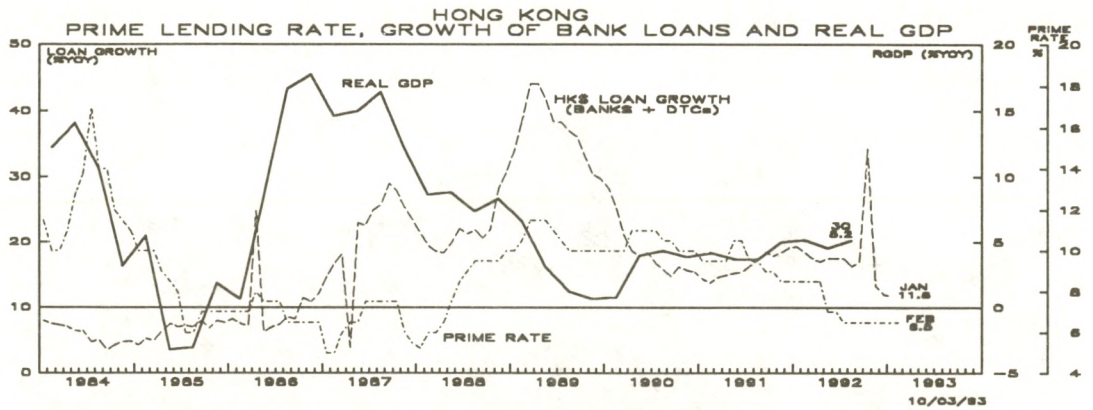
The proposed 1993-94 Government Budget contained the following key points:

1. A rise in recurrent expenditure by around 5.2% in real terms. (All rates of growth are quoted in real terms.) The significant items of this expenditure are: housing and community expenditure (health, education & environment) which will rise by 9% and 5.6% respectively.
2. The non-recurrent component of public expenditure is to grow by 30.9%. The largest elements in this category -- infrastructure, housing and social services (health) -- will benefit from significant rises in capital spending of 25.2%, 12.8% and 13% respectively.
3. Tax concessions via raising the tax threshold to middle income classes, which will reduce revenue to the authorities by an estimated HK\$2.6 bn.
4. Based on a projected 5.5% real GDP growth in 1993-94, a planned budget deficit of HK\$3.36 bn is envisaged.
5. Expectations of future deficits will reduce the present HK\$120 bn accumulated surplus to HK\$78 bn by 1997.

Some commentators have remarked that there are inflationary consequences of the forthcoming series of budget deficits. This is not so in the traded goods sector. Consider the position of the government. Some of the government's accumulated surpluses are held as HK\$ deposits in the Hong Kong banking system, and some are managed by the Exchange Fund which holds them as foreign currency bonds or deposits in banks abroad. The government has made a decision to run down some of its accumulated surpluses by incurring a string of deficits. In doing this, if the government HK\$ deposits exceeding 1 month in maturity within the Hong Kong banking system are run down, there will be a counteracting increase in privately held deposits within the banking system. No net change in the deposits constituting HK\$M3 results from this, merely a change in deposit ownership. Clearly this would not be an inflationary process.

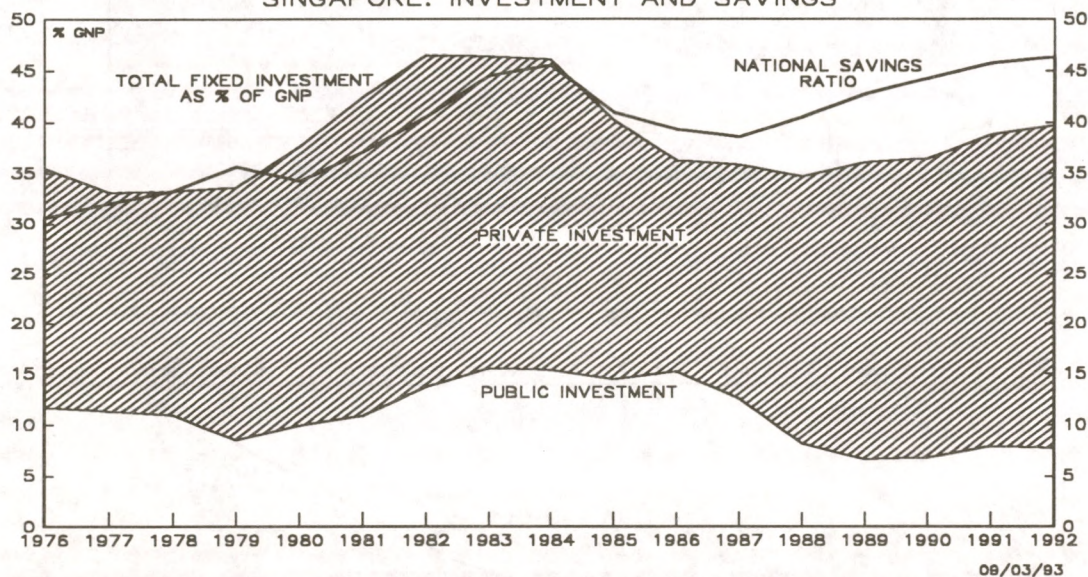
However, the government may decide to finance its spending from its foreign exchange deposits managed by the Exchange Fund. This is brought about in two stages. In the first stage, the Exchange Fund must sell the government's foreign currency deposit, held abroad, and purchase a HK\$ deposit. In doing this, the Hong Kong banking system experiences a fall in private sector HK\$ deposits and a rise in government HK\$ deposits. No change to HK\$M3 occurs here. In the next stage the government runs down its newly transferred HK\$ deposit. This, as described in the previous paragraph, entails a redistribution of HK\$ deposits within the banking sector. At the end of this process HK\$M3 would not have changed. By running down its reserves in this way the government is not creating additional inflation at either of the two stages.

An explanation of Hong Kong's current historically high inflation rate is found by considering the enormous shift in Hong Kong's industrial structure. Over the past decade, Hong Kong has experienced higher productivity growth in its tradeables sector than that in the US. This, along with the HK\$-US\$ link, has served to keep tradeable price and wage inflation in Hong Kong competitive with that in the US. The resultant strong export demand for tradeables has boosted tradeable earnings, which have created a "spillover effect" into the Hong Kong services (non-tradeables) sector. The higher spending in the services sector brings about an expansion in the services industry and higher service price inflation, unsupported by rises in its productivity. The government spending allocated to developing service sectors, for example, the transportation sector, can be seen as a response to this structural change in industry, not a cause. In conclusion, the forthcoming deficits cannot be seen as a cause of the structurally induced inflation in Hong Kong. In addition, the deficits do not generate any monetary expansion, and therefore cannot lead to inflation.



SINGAPORE BUDGET: A WELCOME RELAXATION OF POLICY

SINGAPORE: INVESTMENT AND SAVINGS



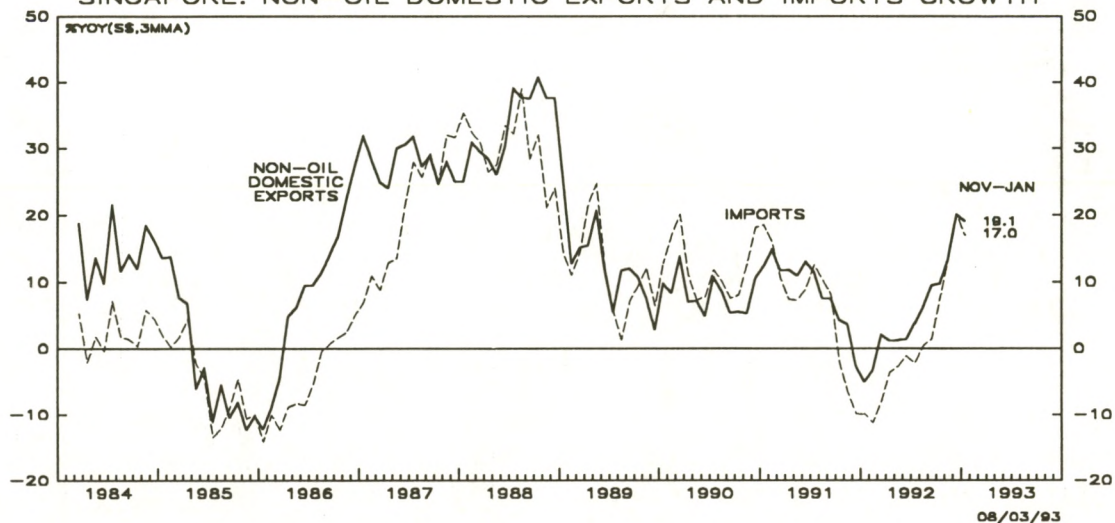
Although the 1993-94 budget contained few surprises it demonstrated that Singapore has started to relax its iron fiscal grip. Certainly such a relaxation is long overdue. The government's budget surplus is estimated to have reached 5.7% of GDP in the year to March 1993 while the consolidated public sector surplus was probably twice this figure. This contributes to a savings rate that stood at 47% at the end of 1992.

For fiscal 1993, the surplus is set to fall to 2.5% of GDP, freeing up additional resources for the private sector. This will be achieved by, amongst other measures, a 3% reduction in both corporate and top-rate income tax to 27% and 30% respectively, and by the granting of a one-off 5% rebate on personal income tax. The 3% Goods and Services Tax (GST) to be introduced in fiscal 1994 will do little to dampen sentiment. Its low absolute level (New Zealand's GST is 12.5%, for example), further direct tax cuts and various rebates and exemptions should minimise any pain.

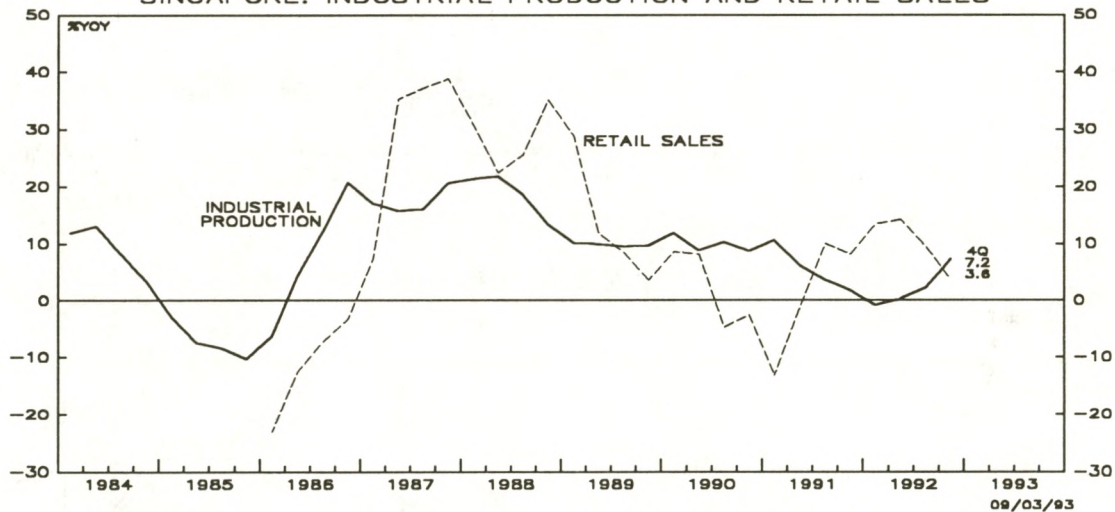
Although the government has been widely criticised for keeping fiscal policy overly tight, thus crowding out the private sector, the latter has shown itself more than able to restrain its own spending. In 1991 the public sector savings rate rose an estimated 3% of GDP yet the gross national savings rate still increased 2% to 46% suggesting that private and corporate savings were only run down by 1%. During 1992, the public and corporate savings rates were probably flat yet the overall savings rate rose further. If crowding out were a real problem then given the high absolute level of savings, private dissaving would be expected.

The recovery apparent in Singapore's exports over the recent months should translate into increased consumer and corporate confidence, and thus an increase in loan demand and domestic expenditure. The paring back of the public sector is therefore timely and should facilitate this process. However, (initially tentative) measures also introduced to boost overseas investment and free up the use of CPF funds are probably more important in the long run. The high domestic savings rate is a reflection of a lack of investment opportunities at home, and an inability or unwillingness to transfer resources abroad. Better deployment of these excess savings is essential if Singapore is to maintain its high growth path.

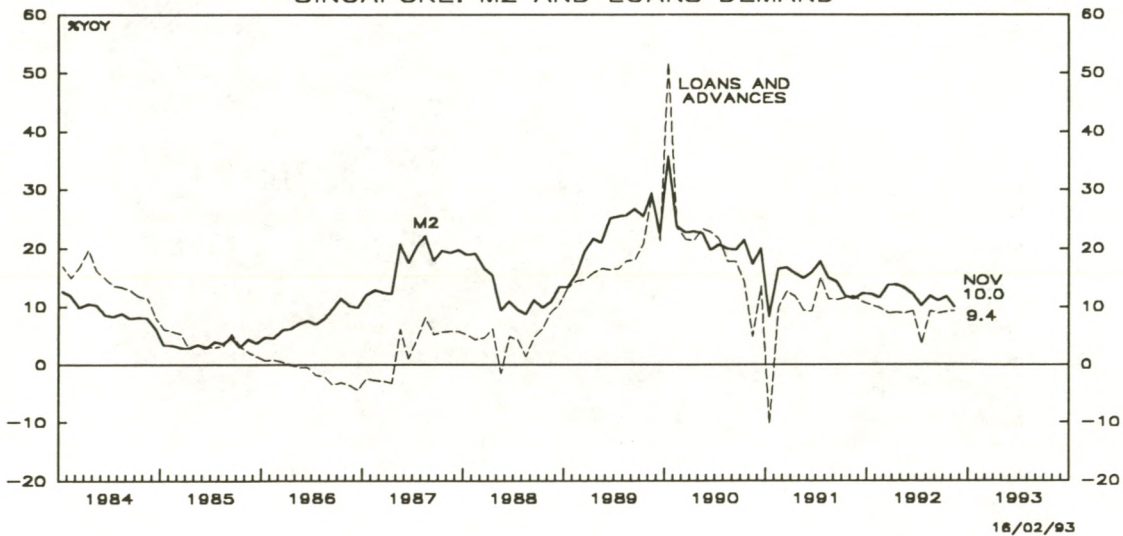
SINGAPORE: NON-OIL DOMESTIC EXPORTS AND IMPORTS GROWTH



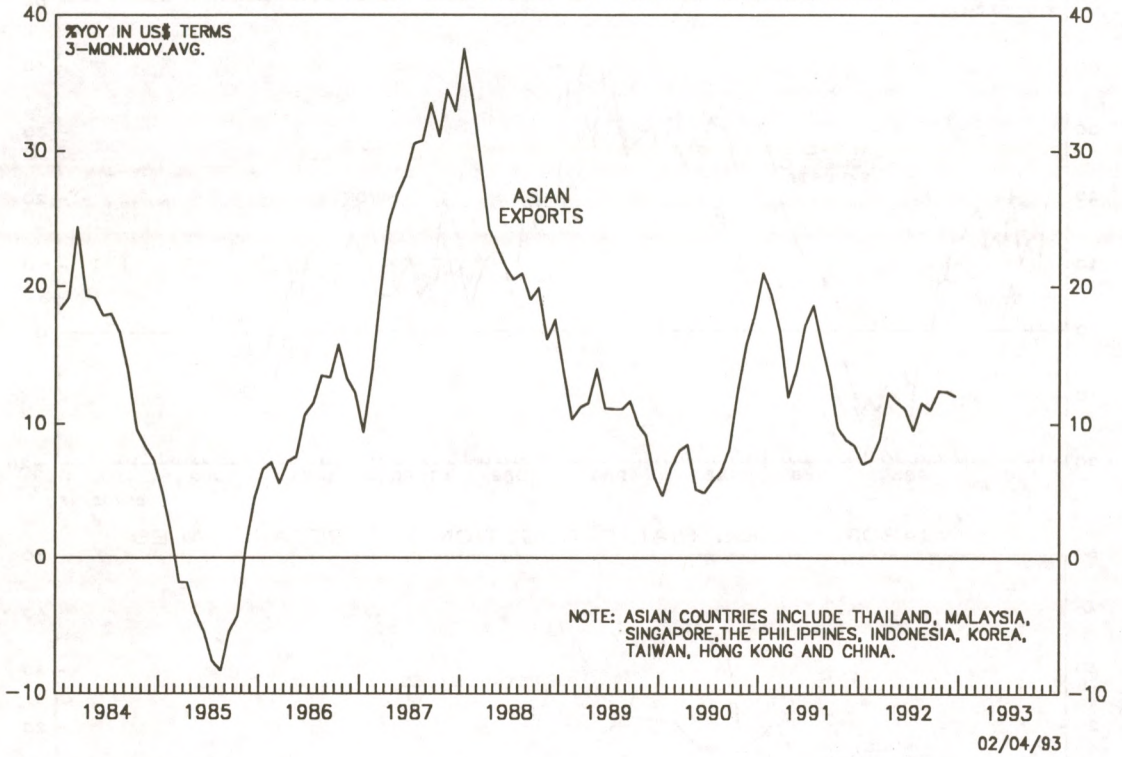
SINGAPORE: INDUSTRIAL PRODUCTION AND RETAIL SALES



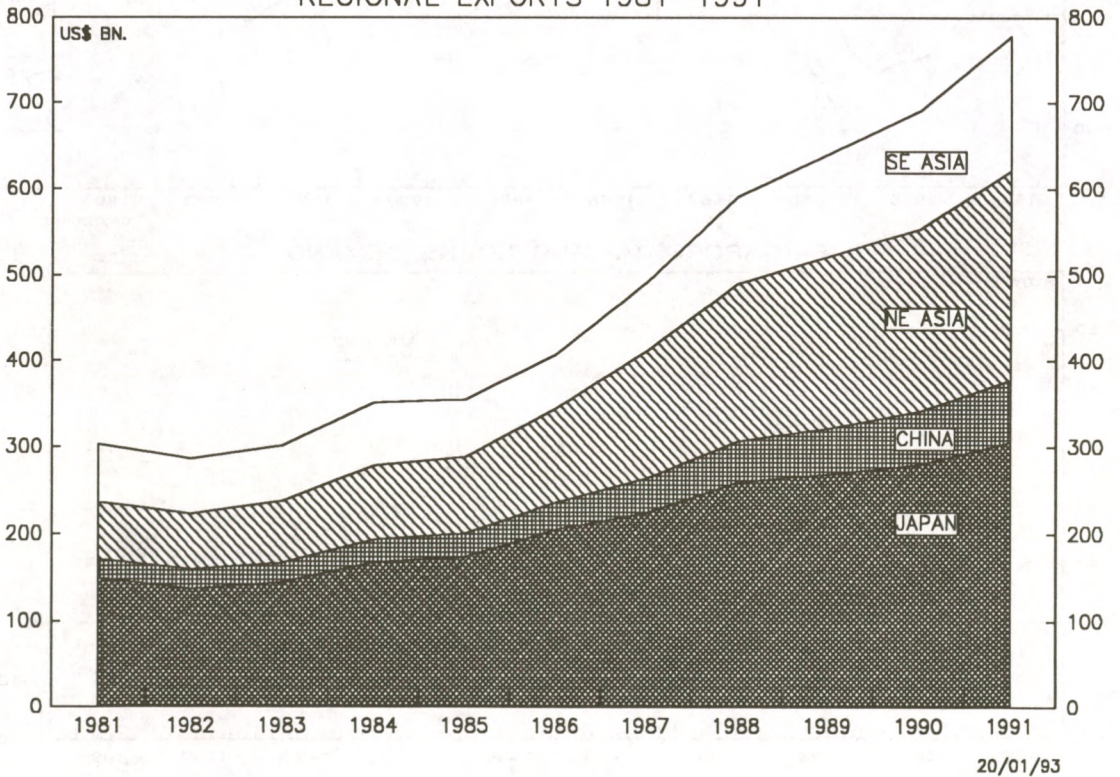
SINGAPORE: M2 AND LOANS DEMAND



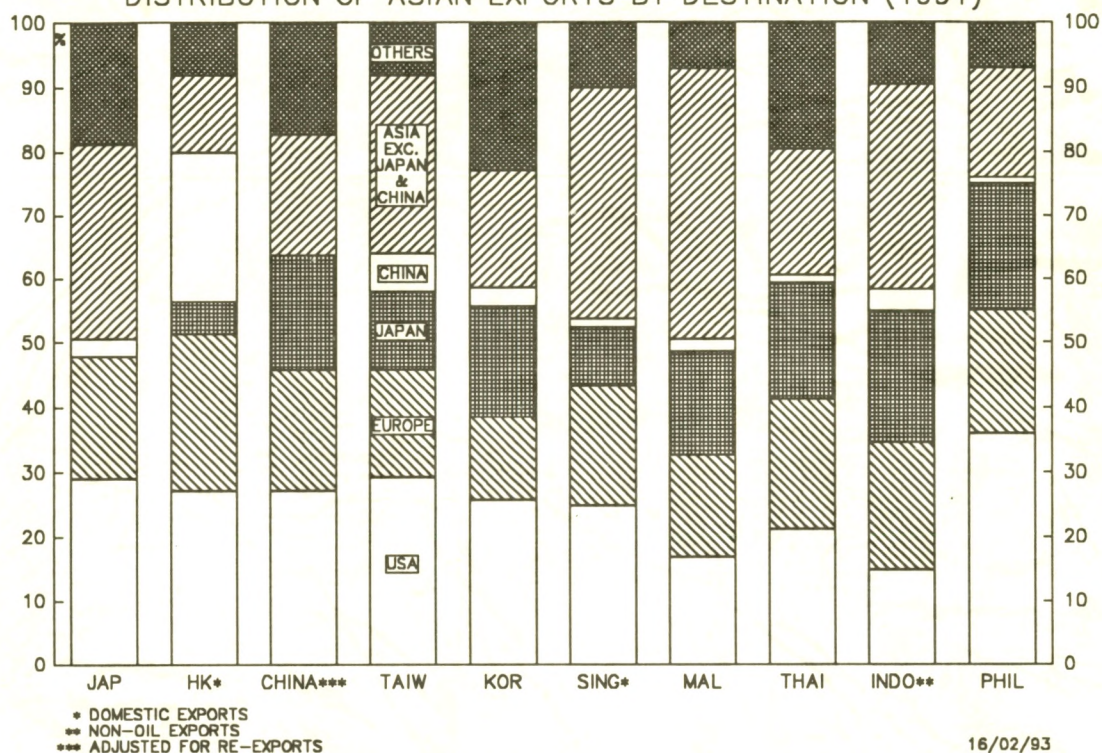
GROWTH OF EXPORTS OF ASIAN ECONOMIES



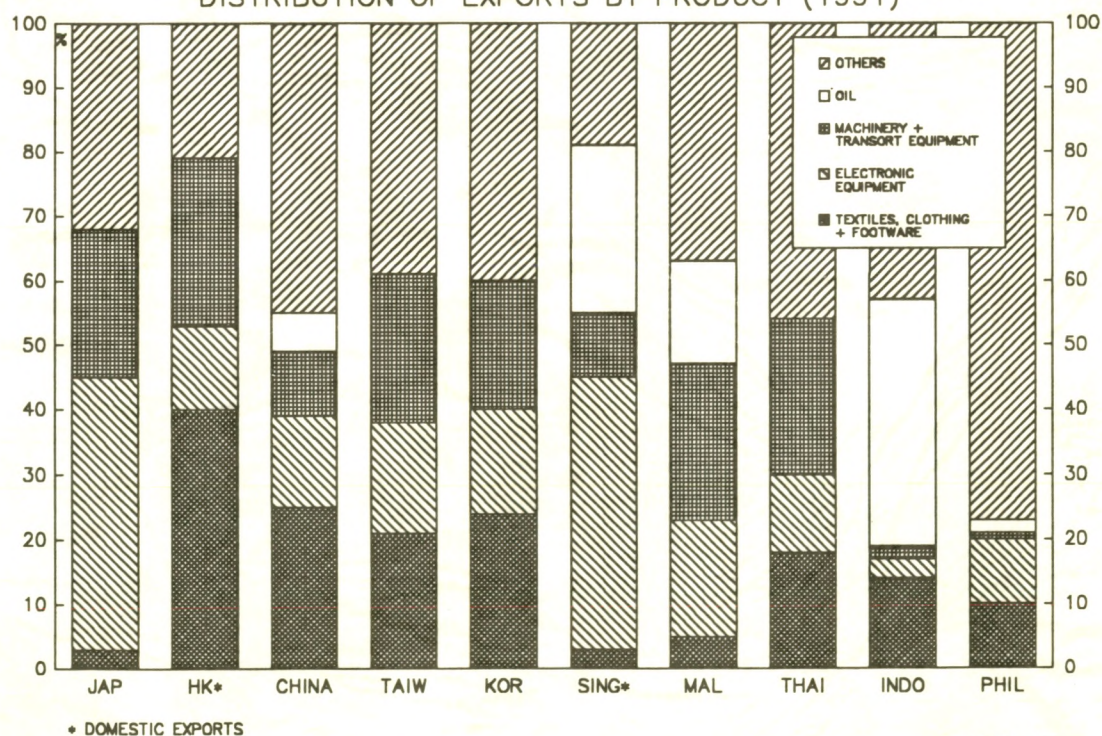
REGIONAL EXPORTS 1981-1991



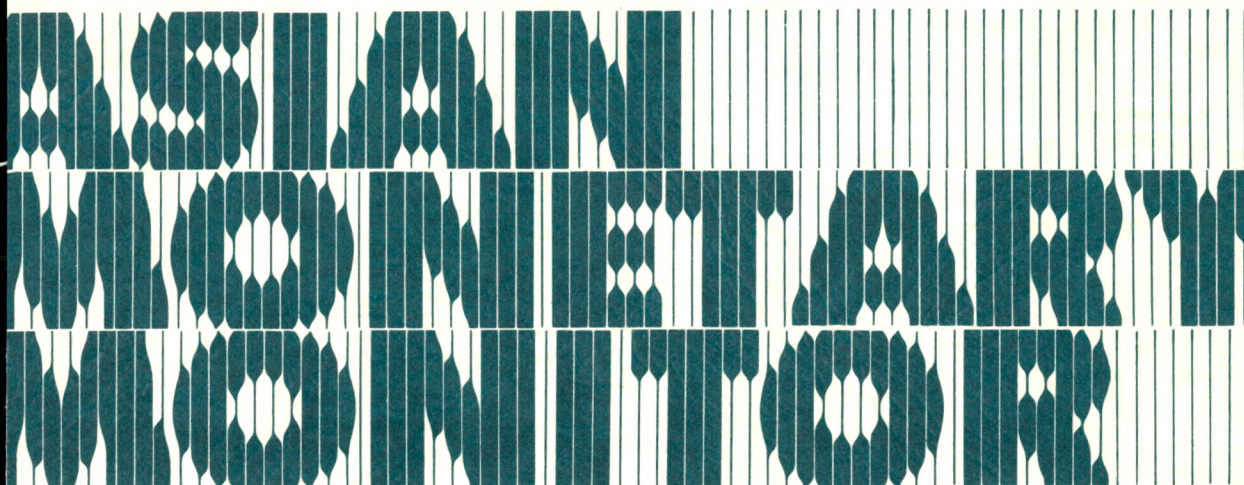
DISTRIBUTION OF ASIAN EXPORTS BY DESTINATION (1991)



DISTRIBUTION OF EXPORTS BY PRODUCT (1991)







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INDONESIA CONVALESCENCE ALMOST COMPLETED

Introduction

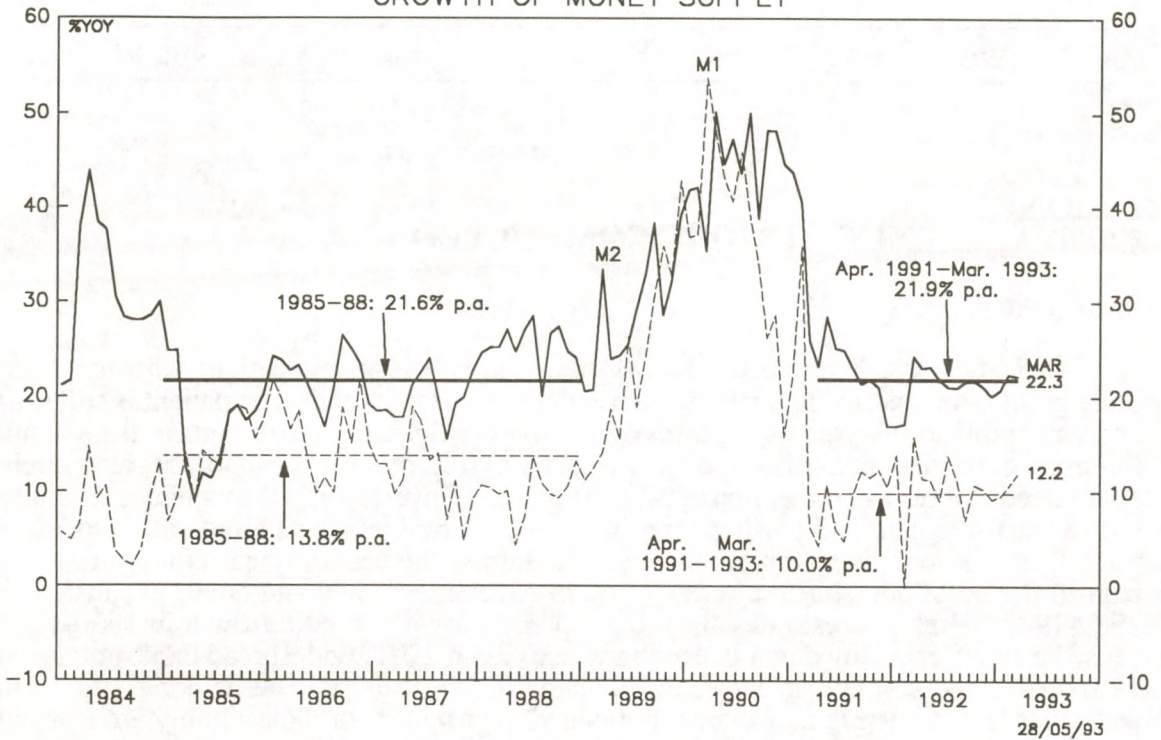
In metaphorical terms, the Indonesian economy is like a patient who has been undergoing a long period of convalescence which is nearing its end. The patient is still frail and vulnerable to relapse as symptoms of the illness still emerge from time to time (bank failures, corporate bankruptcy etc). Hence, a full recovery cannot be absolutely guaranteed without a continuation of careful nursing. Nevertheless, the patient is certainly out of intensive care and participating in regular therapy sessions aimed at restoring a normal life as soon as possible. In economic terms, the economy has come through a painful period of adjustment after a period of excessive money and credit expansion in 1989-1990. High interest rates and an abrupt slowdown in credit growth in 1990-1991 caused a significant slowdown in economic activity in 1991, widespread bankruptcies in 1991-1992, and continuing bad loan problems for the banks. The banking system in particular is still nursing its wounds, but many other sectors of the economy are starting to show healthy signs of recovery. As the problems of the adjustment to lower rates of money and credit growth dissipate, interest rates can be expected to fall further, growth will rise somewhat, and inflation can come down. The outlook for investment, particularly from overseas, is especially bright, though much more could be done to make the Indonesian playing field more even as between locals and foreigners and as between different sectors.

This article first considers monetary policy, economic growth and inflation. Second, we focus on the banks and the adjustments which are occurring in their balance sheets as a result of the economic shake-out. Third, we review the balance of payments and the prospects for Indonesia's downward crawling peg -- a policy which has been in place since the last explicit devaluation of the Rupiah in September 1986. The conclusion, to revert to the metaphor above, is that, assuming a continuation of post-operative nursing care, there is no reason why the patient should not return to a state of robust health within quite a short space of time -- to be measured in months rather than years.

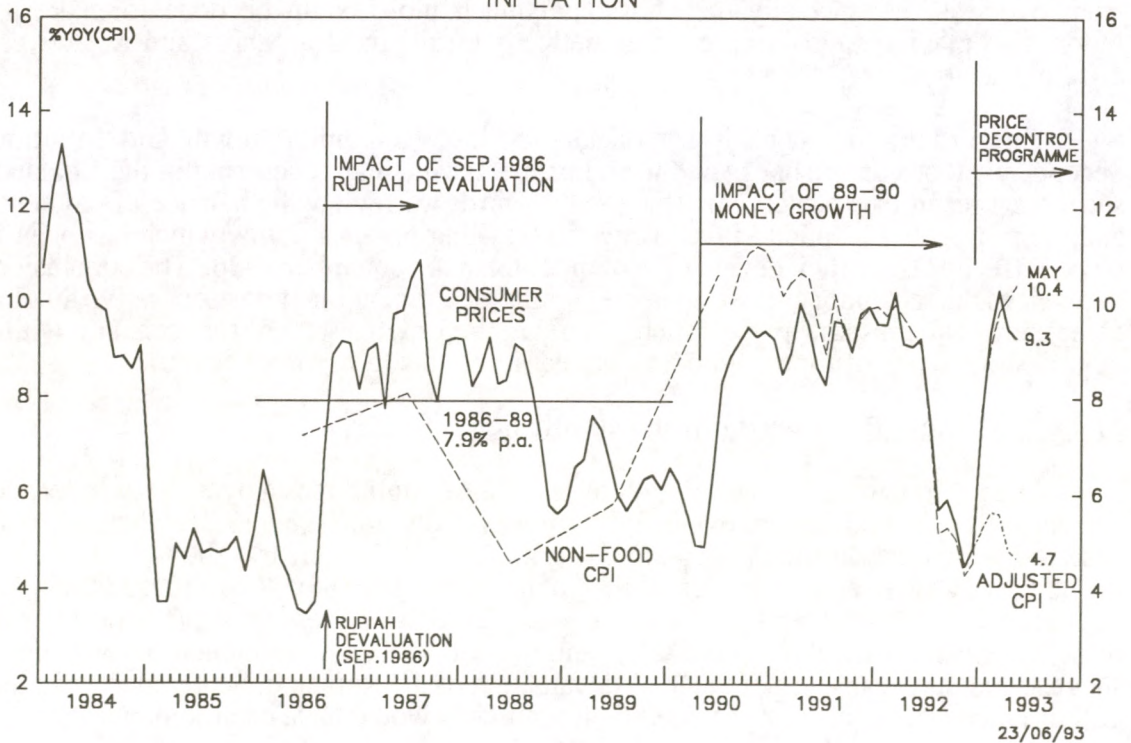
Monetary Policy, Economic Growth and Inflation

Chart 1 shows the rates of growth of M1 and M2 in Indonesia over the past decade. The unfortunate and aberrant explosion of money growth in 1989-1990 (when a broad-based banking liberalisation programme was implemented) is clearly shown. However, the point we wish to emphasise here is that in the period prior to that episode, M1 and M2 both grew at roughly steady rates of 13.8% and 21.6% p.a. respectively, over a period of four years between the start of 1985 and the end of 1988. Examination of Chart 2 suggests that in the absence of the 30% devaluation of the Rupiah in September 1986, the CPI inflation rate in the four years 1986 through 1989 would have been somewhere in the range 4-6%.

INDONESIA: CHART 1
GROWTH OF MONEY SUPPLY



INDONESIA: CHART 2
INFLATION



Since monetary growth of both M1 and M2 has returned to the broad range seen in 1985-1988 with M1 averaging 22% p.a. since the start of 1991 and M2 averaging 12% p.a. over the same period, the question arises as to whether it is reasonable to expect inflation to return to the trend (ie. devaluation-adjusted) rates of 4-6% p.a. seen in 1986-1989. To answer this question, we need to consider (a) the potential real growth rate of the Indonesian economy under present conditions, (b) the demand for money at current levels of income ie. income velocity, and (c) the trend (as opposed to the measured) rate of inflation. On the first topic -- the potential real economic growth rate -- there can be little doubt that this has risen in recent years. Non-oil manufacturing as a percentage of the GDP has risen from 11.6% in 1985 to 16% in 1992, and is estimated to rise to over 22% before the turn of the century. Similarly, non-oil exports have doubled from US\$12.2 billion in 1988-1989 to an estimated US\$24.6 billion in the fiscal year 1992-1993, giving an average growth rate of 18% p.a. Non-oil manufacturing exports grew even faster at 26% p.a. over the same five year period. As manufacturing becomes a more important part of the Indonesian economy, and as long as it is starting from a relatively small base, the gains in productivity as Indonesia's huge (188 million) population shifts from the farm to the factory can be immense. In due course, as Indonesia industrialises further, the economy should be able to maintain even faster real growth rates of perhaps 9-10% p.a. in real terms. For the time being, it would appear that the real growth rate has risen from 6.5% p.a. in 1975-1983 and 5% p.a. in 1983-1987 to nearer 7% p.a. in 1988-1992. In short, the real growth rates experienced in 1986-1989 when money growth was steady and core inflation was low are currently being exceeded and may well be exceeded by more in the coming years. Therefore the same approximate money growth rates today as in the period 1986-1989 will, given the higher real growth rate, result in a lower inflation rate than at that time, *ceteris paribus*.

The important *ceteris paribus* qualification refers to the assumption that the demand for money in Indonesia will grow at roughly the same rate as in the past. In practice, as countries grow richer and particularly as the economy enters the rapid growth phase experienced by many East Asian "tiger" economies in recent years, the demand for money actually rises more than proportionately with real income. If Indonesia's experience conforms at least broadly to this East Asian norm, then we should expect the rate of absorption of money to rise relative to real incomes. In effect, our expectation would be that income velocity would fall, and therefore more money would be required to maintain any given inflation rate. Conversely, a money growth rate of 22% p.a. (for M2) would probably be consistent with a lower inflation rate over the next few years than it was in the past.

Finally, with regard to the core rate of inflation in Indonesia today, it is important to understand just how much of the recent surge in the CPI is due to specific price decontrol actions by the government rather than to any underlying surge of demand in the economy. In his 1993-94 budget speech on January 9th, President Soeharto announced the raising of domestic fuel prices with the aim of eliminating budgetary subsidies for all fuel products (with the exception of a lower and temporary kerosene subsidy). Retail prices for diesel, fuel oil and aviation fuels were raised to world market levels, while the effective tax on petrol was raised to 66% (which enabled kerosene, which is widely used by households for cooking, to continue to be cross-subsidised at a lower 33% rate). The overall price increase amounted to 24%, and accounted for 2.1 percentage points of the 2.9% jump in the CPI in January over December. Simultaneously, the government announced an increase in cement prices of 9.3%, though this was intended to take account of the final price increases. Naturally, the fuel price increases led to increases in electricity tariffs,

and there were subsequent knock-on effects on other sectors such as food, transportation and other goods and services. Only some of these were recorded in the January CPI increases. In February and March, there were further significant CPI increases, resulting from the same measures of 2.0% and 1.3% respectively. Adjusting the CPI in Chart 2 for the once-for-all fuel price increases produces an adjusted CPI of only about 5% on a year-on-year basis. Separately, it should be noted that government expenditure will fall by approximately Rp. 1.3 trillion p.a. as a result of the abolition of the subsidy. In sum, the reported or measured year-on-year CPI inflation in Indonesia will continue to give a distorted view over the rest of this calendar year, but the rate should drop sharply in the first quarter of 1994. Core inflation, in other words, is already in the 4-6% range and can reasonably be expected to fall below this as long as money growth remains roughly on its present course.

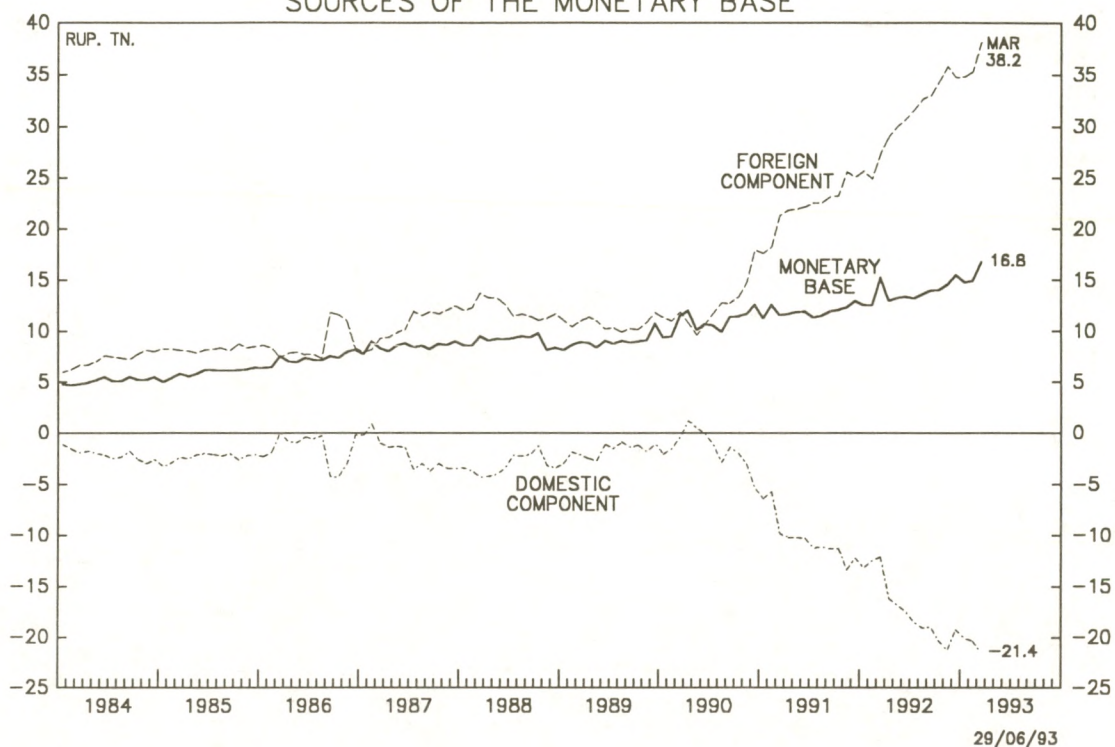
Money growth is the next issue we turn to because the rate of monetary growth will depend very much on the developments affecting interest rates and the composition of bank balance sheets.

Developments in the Banking System

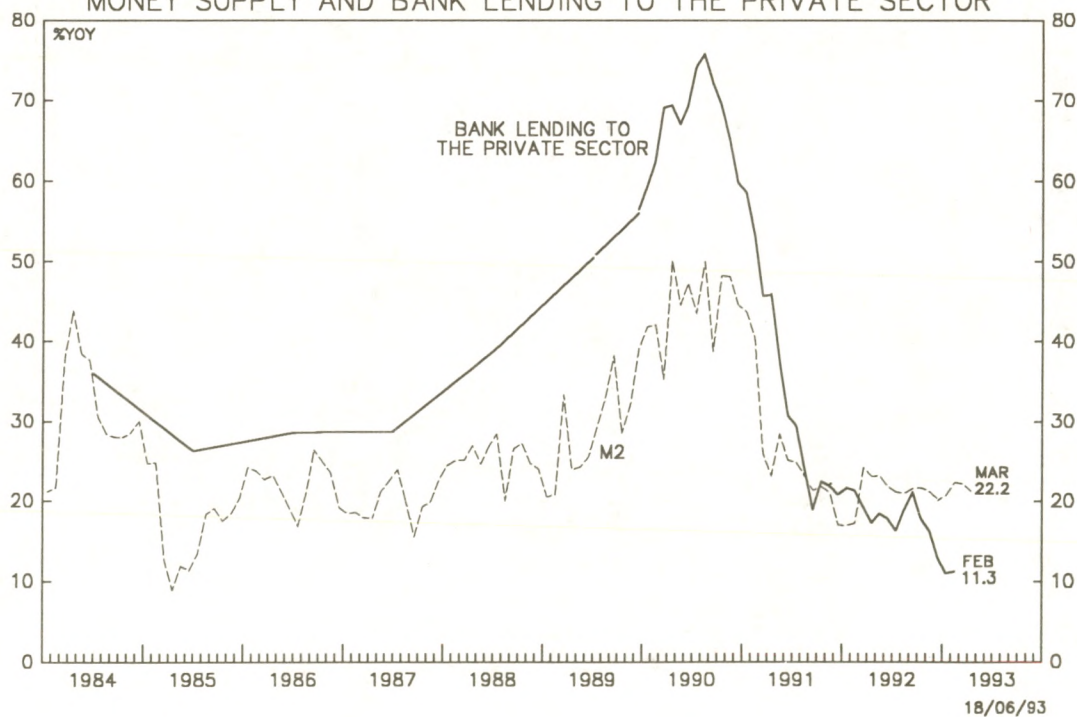
The problems of Indonesia's banking sector were most clearly dramatised in the collapse of Bank Summa in October 1992. The bank had lent heavily to the affiliated Summa Group and to friends of the founder and chairman, Edward Soeryadjaya. The Summa Group had invested large amounts in the hotel and property sectors at a late stage in the economic upswing. In addition to raising concerns about the regulatory supervision of Indonesian banks, this incident was a natural outcome of the money and credit squeeze that had been imposed over the two preceding years. At the central bank level, one immediate consequence of the tightening up of policy following the June 1990 "Sumarlin Shock I" and the February 1991 "Sumarlin Shock II" was the shift in composition of assets corresponding to the monetary base shown in Chart 3. The obligation imposed on state-owned enterprises to buy SBI's or certificates of deposit issued by Bank Indonesia (BI), the central bank, at once led to a fall in the domestic components of the base which until that time had been an accommodating element of the rapid monetary growth of 1989-1990. Since that time, the willingness of BI to use SBI issues to restrain domestic credit expansion and/or to sterilise foreign capital inflows has been impressive. In this section, we shall only consider their use in the domestic context, leaving their role as sterilisation instruments to the next section on the balance of payments.

The damage done by the liquidity squeeze as money growth rates fell from nearly 50% in 1990 to below 20% by the end of 1991 was extensive. The property sector and construction were especially hard hit, as was the financial sector generally from stockbroking through finance companies to the banks themselves. The impact on the banks has been most obvious in the collapse of bank lending from over 70% rates of growth in late 1990 to just 11.3% by February 1993 (see Chart 4). The same chart also shows how bank lending growth has slowed to a rate significantly below the M2 growth rate. Indeed the divergence of bank lending growth from M2 growth in Indonesia is reminiscent of a similar divergence in Malaysia, except that in the Malaysian case M2 has accelerated under the influence of foreign capital inflows, while bank lending growth has remained subdued

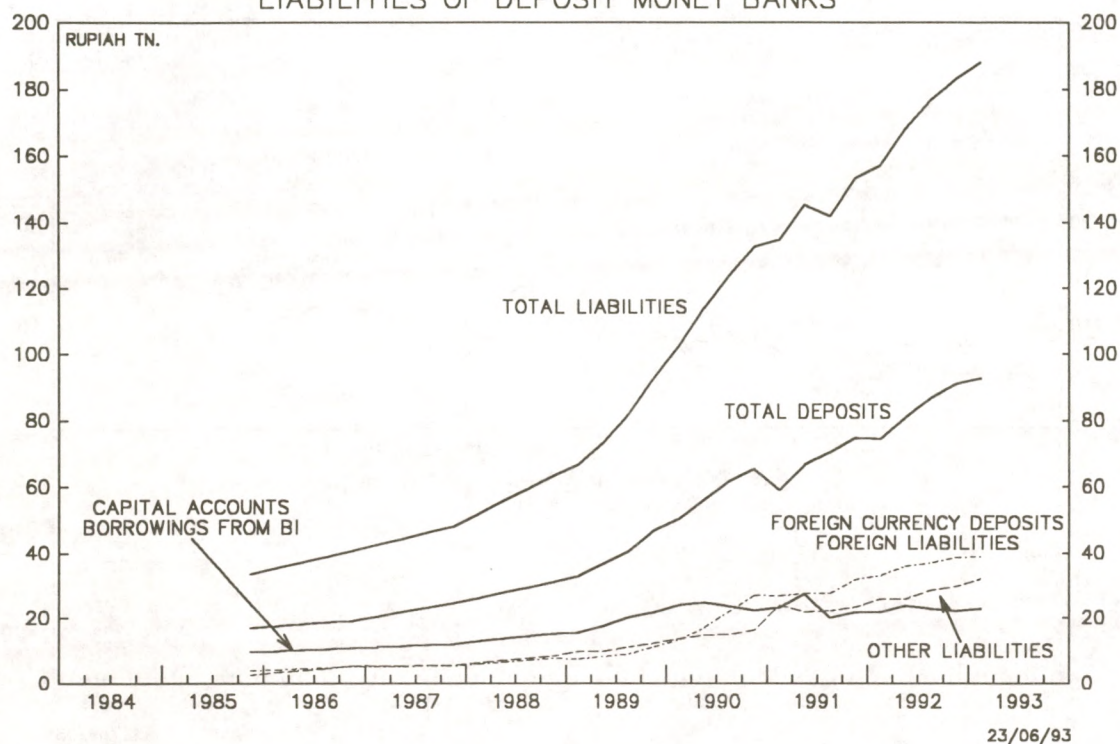
INDONESIA: CHART 3
SOURCES OF THE MONETARY BASE



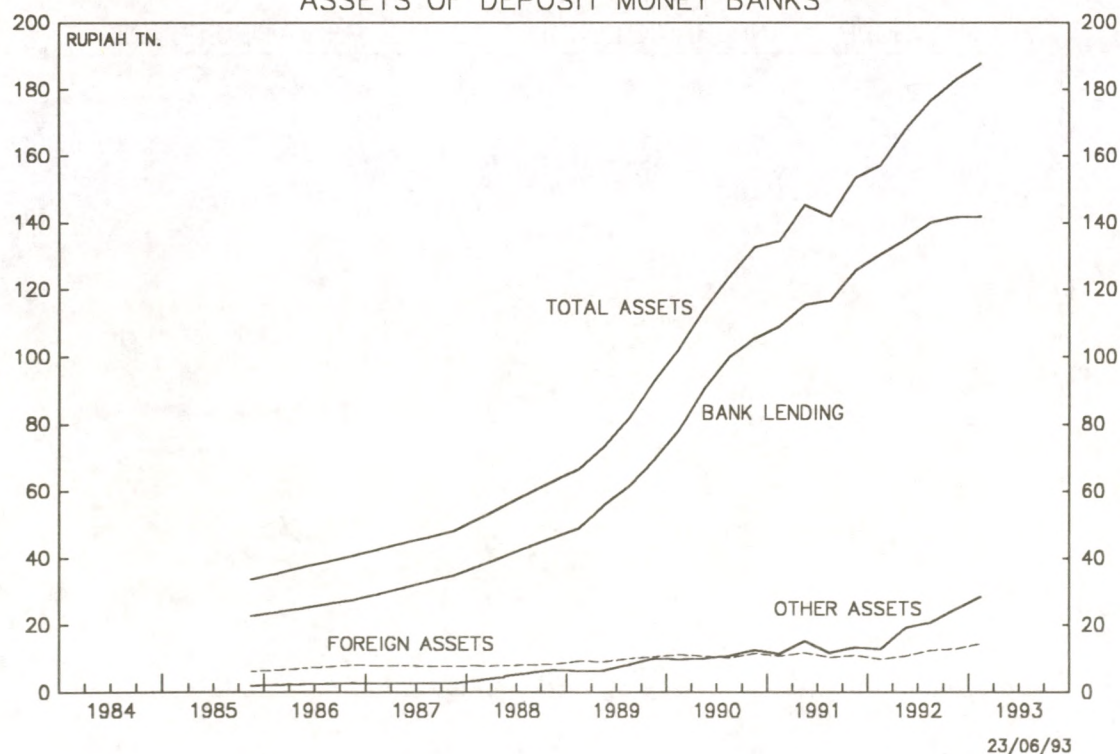
INDONESIA: CHART 4
MONEY SUPPLY AND BANK LENDING TO THE PRIVATE SECTOR



INDONESIA: CHART 5
LIABILITIES OF DEPOSIT MONEY BANKS



INDONESIA: CHART 6
ASSETS OF DEPOSIT MONEY BANKS



rather than continued to weaken. In the case of Indonesia, the issue of SBI's by the BI has been a godsend for the banks, for foreign investors as well as for some of the more cash rich corporations. For as the woes of the economic downturn have gradually percolated through the economy, the banks have been able to invest in first class paper issued by BI at market rates instead of either extending further loans to dodgy borrowers or lending at lower rates in the interbank market.

The impact on Indonesian banks' balance sheets can be seen from studying Charts 5 and 6. On the liabilities side, deposits have continued to grow at a modest pace (reflected in the 20% M2 growth rate), but the main source of growth of funding has been from foreign currency deposits and foreign currency borrowings, both of which picked up significantly after Indonesia's interest rates were raised sharply by the two Sumarlin Shocks. On the asset side, the tailing off in bank lending is only too obvious, as is the sharp rise in other assets since the start of 1992. Since this item includes bank purchases of SBI's, it is evident that the banks have been making use of this instrument to deploy their surplus funds while holding back from lending to the corporate sector. The outstanding volume of SBI's had risen from a negligible level in June 1991 to Rp. 13 billion by August 1992 and over Rp. 21 billion by early 1993. Of these, approximately Rp. 5 billion are estimated to be held by foreigners, another Rp. 8 billion by Indonesian corporate holders, and the remainder by the banks themselves. Since interbank rates have typically been lower than the rate on SBI's (see Chart 7), these spreads have helped to repair the banks' balance sheets. Bank Indonesia has, in fact, been willing to subsidise the banks' recovery by taking losses on its own books (in the form of the difference between the interest payable on SBI's and the yield on its holdings of foreign currency bonds such as US\$ bonds or Yen bonds) amounting to as much as Rp.0.9 billion in 1992.

Equally powerful evidence of the problems of the banks in the very wide spread between lending and deposit rates are reflected in the prime minus 3 month deposit spread or the prime minus interbank spread shown in Chart 8. Until liquidity in the system starts to build up again, these spreads can only be expected to narrow slowly. The next section considers whether liquidity can increase for balance of payments reasons. Here we consider whether there are domestic reasons to expect any sudden easing in liquidity conditions.

The main clue comes from the BI's recent (May 29) easing of prudential regulations which were widely considered to have been intended to encourage bank lending growth in view of the fact that at 11.1% year-on-year in the first quarter of 1993, it was falling well behind the official target of 17%, which in turn could affect the GDP growth rate. In February 1991, BI had issued regulations (Pakfeb) governing banks' Capital Adequacy Ratio (CAR) their Loan/Deposit Ratio (LDR), the Legal Lending Limit (LLL) and Loans to small businesses (KUK). The new rules announced on May 29, known as Pakmei, included the following:

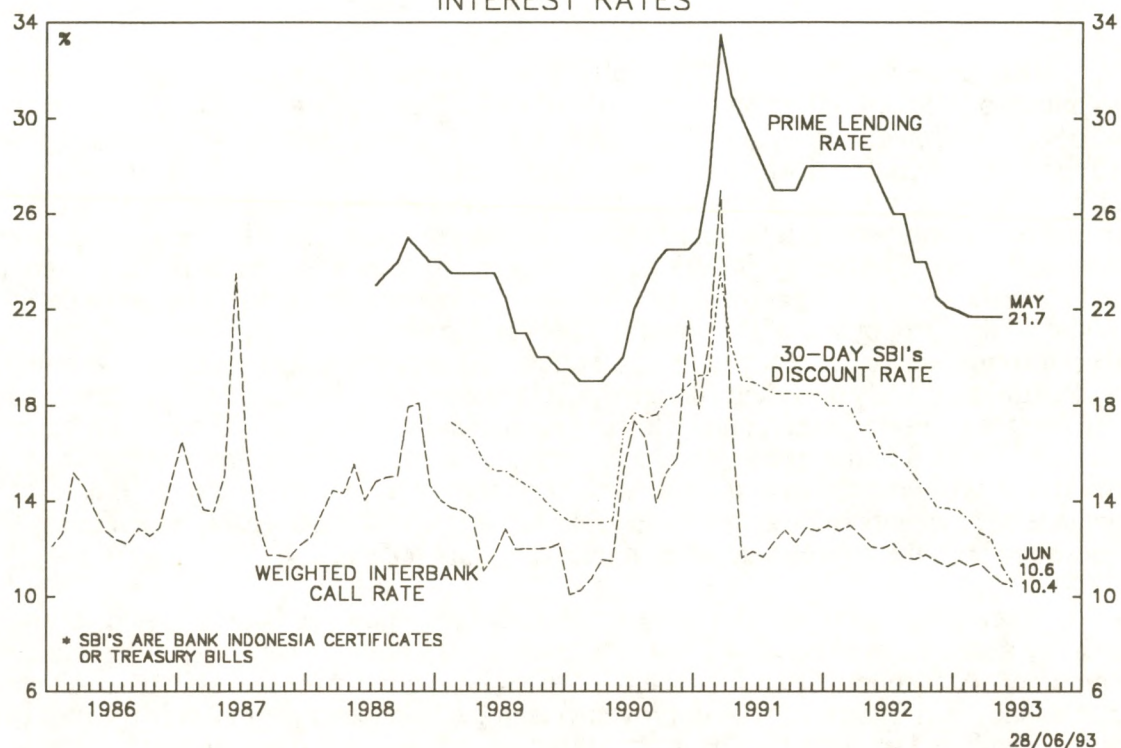
- (i) Banks were allowed to include 100% (compared to 50% previously) of the previous year's profits as capital in the computation of CAR. The deadline for meeting the 8% CAR remains the end of 1993.
- (ii) The risk weightings for undrawn credits and loans to state-owned companies were halved from 100% to 50%.
- (iii) Banks may include capital with deposits for calculation of their loan/deposit ratios.
- (iv) The legal lending limit to individuals and affiliated companies is reduced from 30% of a bank's capital to 20%. Where loans to affiliates currently exceed 50%, as they do in the case of some family-owned groups, deadlines are imposed lowering them to 35% by December 1995 and to 20% by December 1997.
- (v) The percentage of total loans to be allocated to small businesses remains at 20%, but the ceiling on individual loans is raised from Rp. 200 million to Rp. 25 million, and any credits whatsoever under Rp. 25 million are to be regarded as loans to small businesses.

Owing to the stringency of the original Pakfeb regulations, BI appears to have concluded that banks are restricting their lending and seeking to maintain their capital rather than expanding either, and that this is restraining the economic recovery. Measures to ease CAR and LDR would appear to promote bank asset and liability expansion, and hence ease money and credit conditions,. However, the new BI governor recently announced that 195 of the country's 212 banks have already met the 8% CAR requirement set by the BIS, so either the authorities want the 17 banks which have not yet met the 8% requirement to be let off the hook, or they want to back off from the severity of the restrictions as originally set. The real issue, though, is how rapidly BI is easing money market conditions by lowering interest rates or not sterilising foreign capital inflows. Any central bank has the power to do this, but in the case of BI, the SBI's are being issued at a yield which makes them significantly more attractive than either loans to a risky private sector corporate borrower, or lending money to the interbank market where the rates have been around 10%, compared with SBI rates in the 13-19% range since early 1991. In summary, the BI's easing of liquidity ratios will not have much impact in accelerating money and credit growth unless BI simultaneously eases money market conditions further and stops withdrawing funds from the money market via SBI issues - moves which we would judge unlikely in current circumstances.

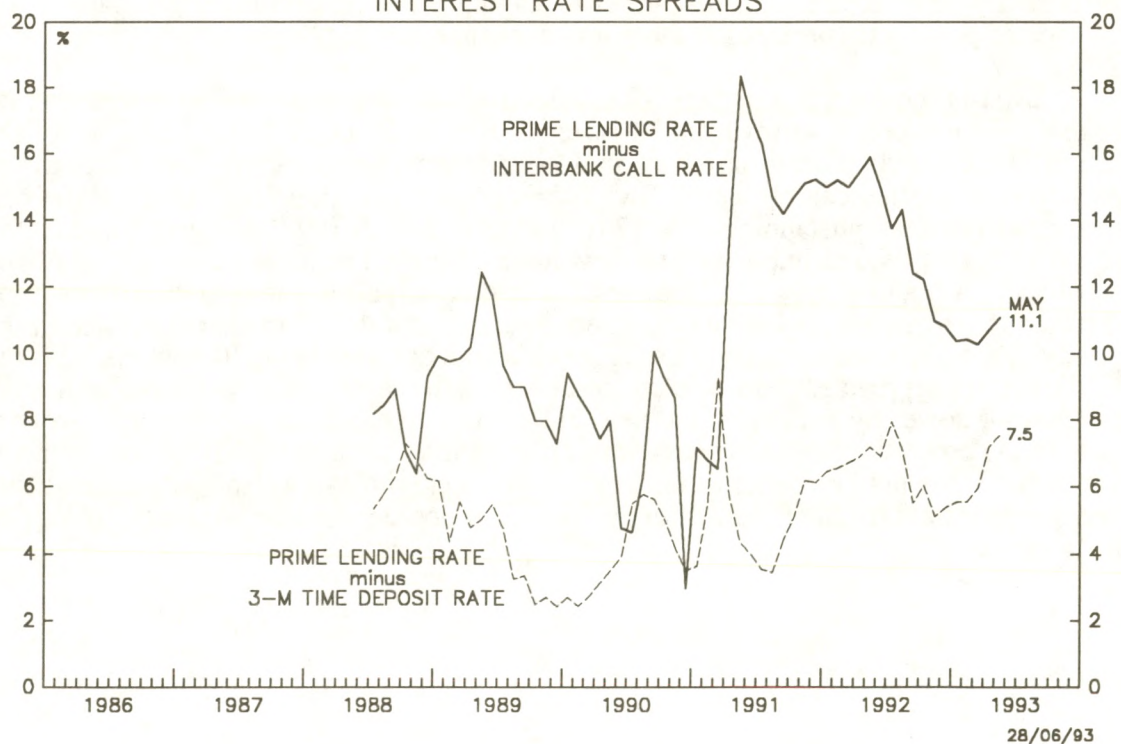
The Impact of the Balance of Payments on Monetary Conditions

The most striking feature of Indonesia's external accounts in recent years has been the rapid growth of non-oil manufactured exports. In 1992, non-oil exports grew by over 26%, far surpassing the subdued 7% growth of non-oil imports. As a result, the non-oil trade deficit was virtually eliminated and the overall trade balance (which includes oil) surged from a surplus of US\$1.5 billion in the fiscal year ending March 1992 to US\$3.9 billion in the year ending March 1993. This trend is reflected in the lower panel of Chart 9, while the upper panel shows how total exports have been growing considerably faster than total imports.

INDONESIA: CHART 7
INTEREST RATES



INDONESIA: CHART 8
INTEREST RATE SPREADS

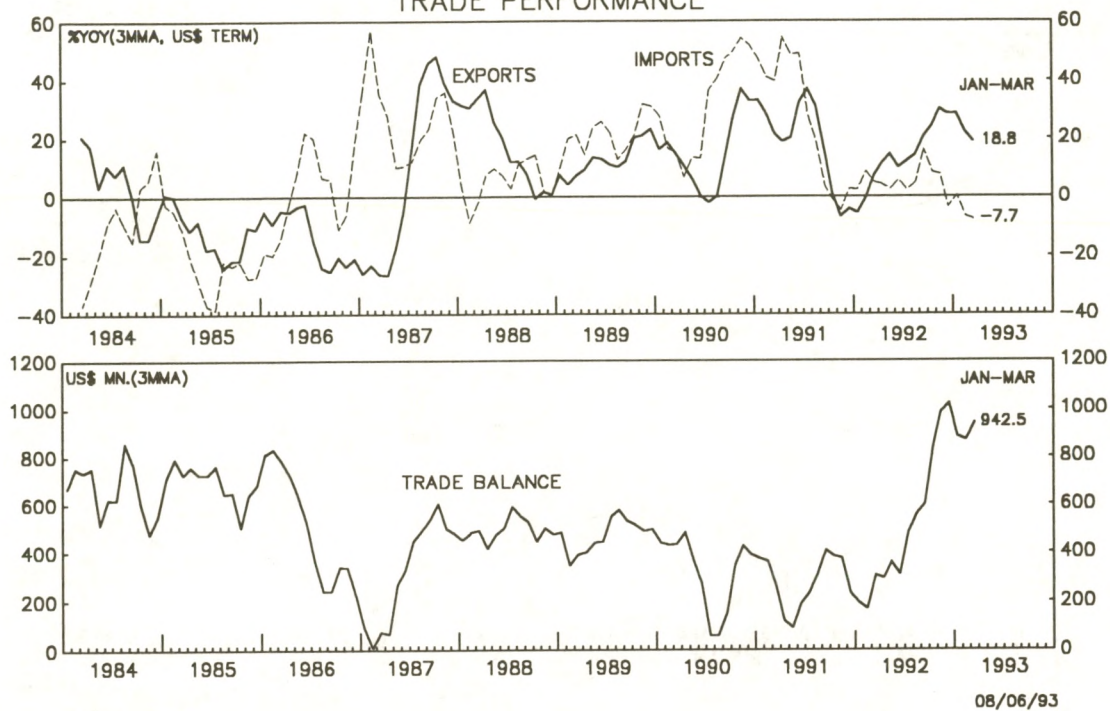


This trade surplus of US\$3.9 billion was, however, entirely offset by interest payments of US\$3.9 billion on overseas debt, with other net factor services and transfers of US\$2.9 billion giving an overall current account deficit of close to US\$3 billion (Chart 10) or 2.4% of GDP. However, because high interest rates have attracted strong capital inflows, Indonesia's capital accounts have been very healthy leading to a US\$6.1 billion increase in combined official foreign reserves and commercial bank foreign assets over the fiscal year. The change in official reserves is also shown in Chart 10. The strength of Indonesia's balance of payments is, if anything, disguised by the current account deficit. While a large proportion of the country's debt is denominated in Japanese yen, and will therefore require larger repayment flows due to the recent yen appreciation, the non-oil trade surplus is likely to widen, foreign direct investment has trebled in the past four years and is set to increase further, and inflows of foreign aid are likely to maintain their current levels of US\$3.8 billion per annum. Furthermore, slower growth of new foreign debt in the future will contribute to a small debt servicing requirement. In sum, Indonesia's balance of payments is looking stronger than it has been for some years, which raises the question about the appropriate foreign exchange rate policy.

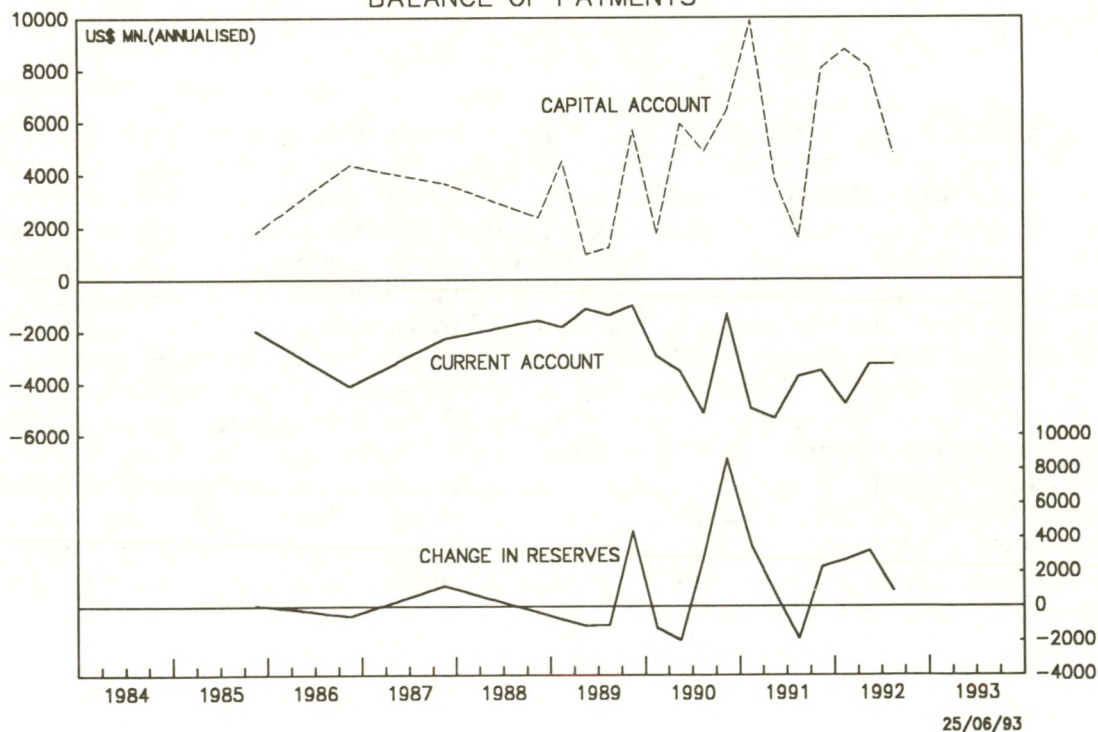
Since the Rupiah devaluation of 1986, the currency has been allowed to crawl steadily downwards at about 4% p.a. vis-a-vis the US dollar. This rate of depreciation combined with modest CPI inflation has led to a mild decline in the real effective exchange rate as shown in Chart 11. The improvements in the balance of payments in the past two years, combined with the decline in core inflation, suggest that if the currency is allowed to continue to depreciate, then the real effective exchange rate will start to decline, leading to a fundamental undervaluation of the currency. This, in turn, would imply that Bank Indonesia would face serious difficulties managing the excess liquidity generated from balance of payments surpluses at the going exchange rate.

Even in the current situation, BI is effectively having to neutralise private capital inflows. The problem arises from BI issues of SBI's. Since these are liabilities of the central bank, funds used to purchase these instruments are diverted from loans to the private sector to the central bank's own balance sheet. As indicated above, about one quarter of the total outstanding (Rp. 22 trillion as of March 1993) was accounted for by foreign holders, which implies that this volume of capital inflows has effectively been sterilised. A better strategy for Indonesia would be to permit the capital inflows to be directed to private sector lending, to allow interest rates to fall further, to abandon the policy of the downward-crawling exchange rate, and to stabilise the Rupiah vis-a-vis the US dollar. In aggregate, this would convert losses at the central bank and losses of foreign purchasing power by holders of Indonesian Rupiah into more stable prices and stronger purchasing power for the country as a whole. In the long term, as the balance of payments strengthens, it would be better to absorb the adjustment through a stronger exchange rate and lower inflation rather than through continued depreciation and another episode of inflation.

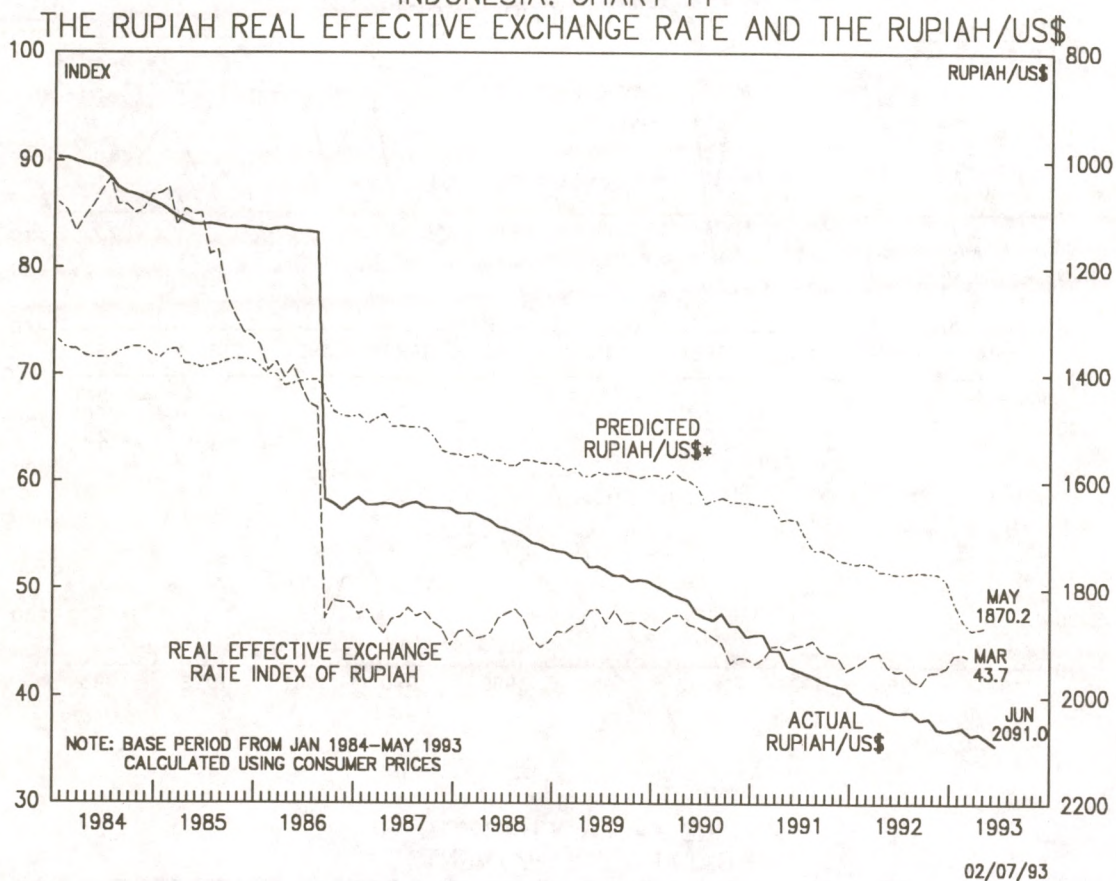
INDONESIA: CHART 9
TRADE PERFORMANCE



INDONESIA: CHART 10
BALANCE OF PAYMENTS



INDONESIA: CHART 11



SUMMARY AND FORECAST: Indonesia's real economic growth rate is gradually rising as the country industrialises. This means that any given rate of money growth will generate a lower inflation rate than in the past. While there are still some problems in the banking system as a result of the overhang of bad debts from the monetary squeeze of 1990-1991, Bank Indonesia is now in a position to ease interest rates gradually through the rest of the year and into 1994. However, since the balance of payments has been improving as a result of the monetary squeeze, the structural transformations of the economy, and the policy of steady Rupiah depreciation, the BI is faced with a short term problem of holding down liquidity. They have tackled this task by issuing SBI's to absorb funds from the private sector, resulting in temporary financial losses for the central bank. A better long term strategy would be to shift from a downward-crawling peg to a stable exchange rate and to allow the combination of a stronger currency policy and lower inflation to permit nominal interest rates to decline. If BI does not abandon this policy over the next year or so, it is likely to face much greater problems in managing the emerging balance of payments surplus, which in turn would spell the danger of another episode of excessive monetary growth and inflation in 1995-1996.

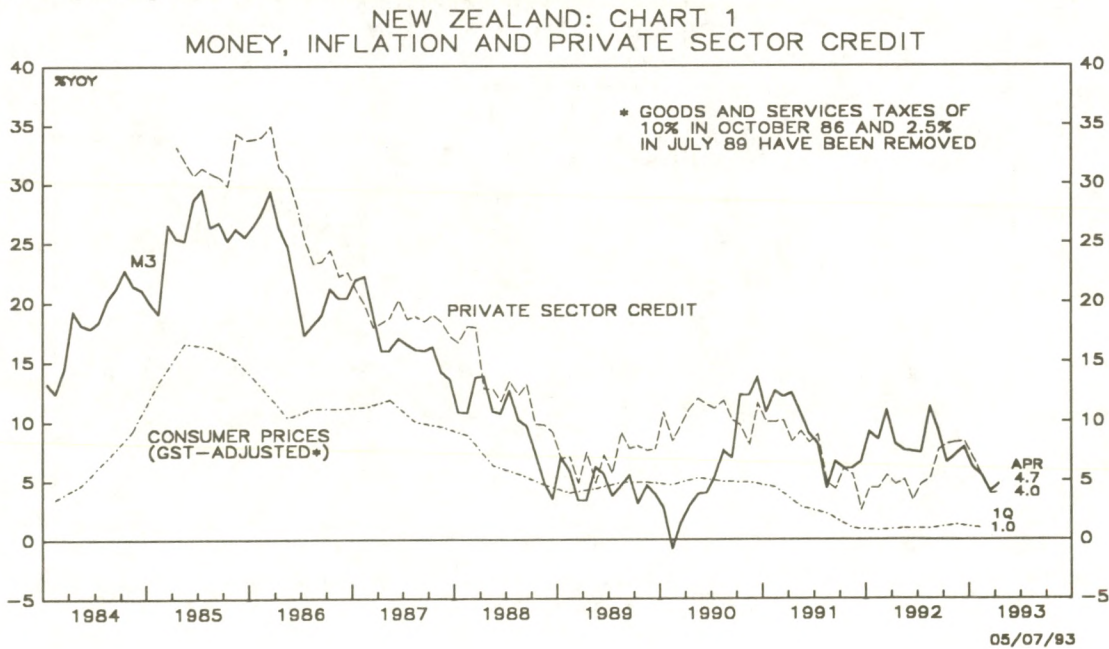
NEW ZEALAND RECOVERY IN THE SHADOW OF AN EXTERNAL SLUMP

Introduction

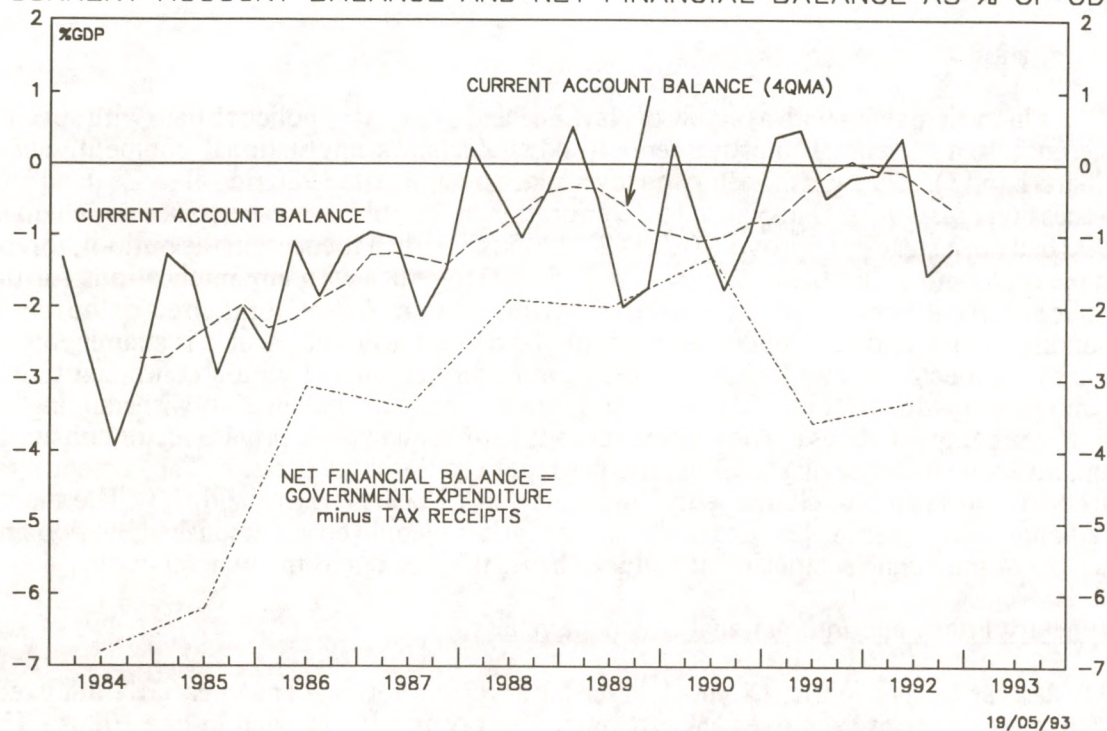
This article starts with a review of New Zealand's monetary policy to date with specific reference to the general improvements in New Zealand's international competitiveness (Charts 1 and 3). The tight monetary policy in place over the late 1980s led New Zealand into a recession in 1990-91. This caused a deterioration in the public sector balance which up to 1990 had been steadily improving (Chart 2). Discussion then focuses on the outlook for the public sector now that the economy is recovering, together with any implications for the public sector balance of a change in government this autumn. After this the effect of the recent economic slump and subsequent recovery on the current account balance is examined. As might be expected, New Zealand's domestic recovery combined with a continued global economic slowdown point to a worsening current account balance notwithstanding its improved competitiveness. The article proceeds with an analysis of private sector consumption, investment and savings, with particular regard to the savings ratio. The current ratio of household savings to GDP is fairly low, at around 5.5% in New Zealand. It will be shown that longer term rises in New Zealand's savings ratio may only be accomplished by reducing the size of the public sector deficit and the "benefits" it offers to the general public.

Monetary Policy and International Competitiveness

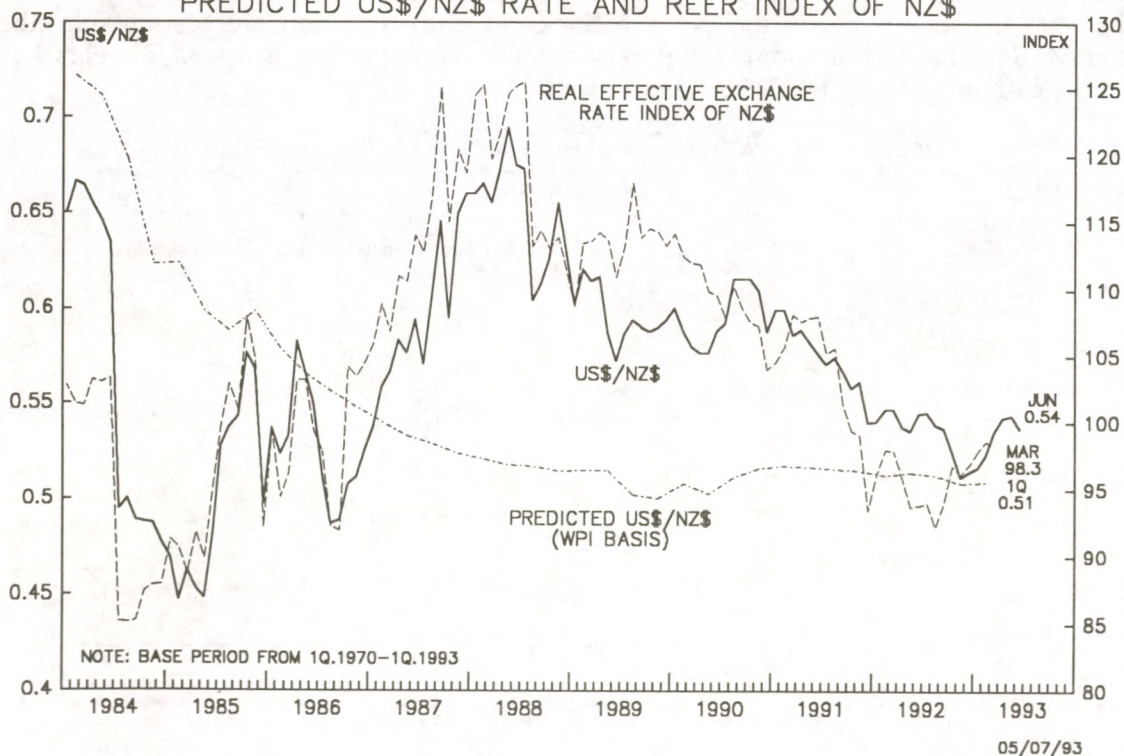
As can be seen in Chart 1, much of the hard work in getting consumer (GST adjusted) price inflation down from over 15% to under 5%, occurred in the mid to late 1980s. The introduction of the Reserve Bank Act in 1989 was to serve mainly as a form of institutional insurance against the short term possibility of higher inflation resulting from a more spend-thrift Finance Minister. Although the inflation target (currently 0-2%) is largely set by the Finance Minister, to whom the Reserve Bank Governor is ultimately accountable, the Reserve Bank has the autonomy to set day-to-day monetary policy as it sees fit. This was not the case previous to the 1989 Reserve Bank Act.



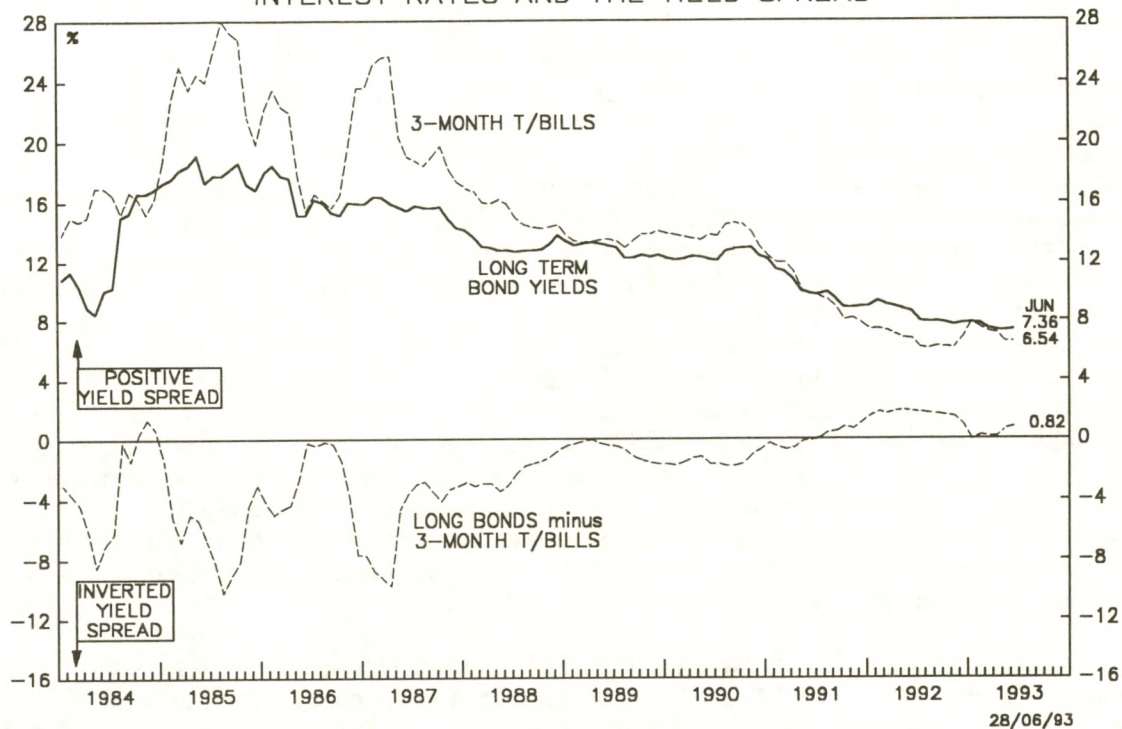
NEW ZEALAND: CHART 2
CURRENT ACCOUNT BALANCE AND NET FINANCIAL BALANCE AS % OF GDP



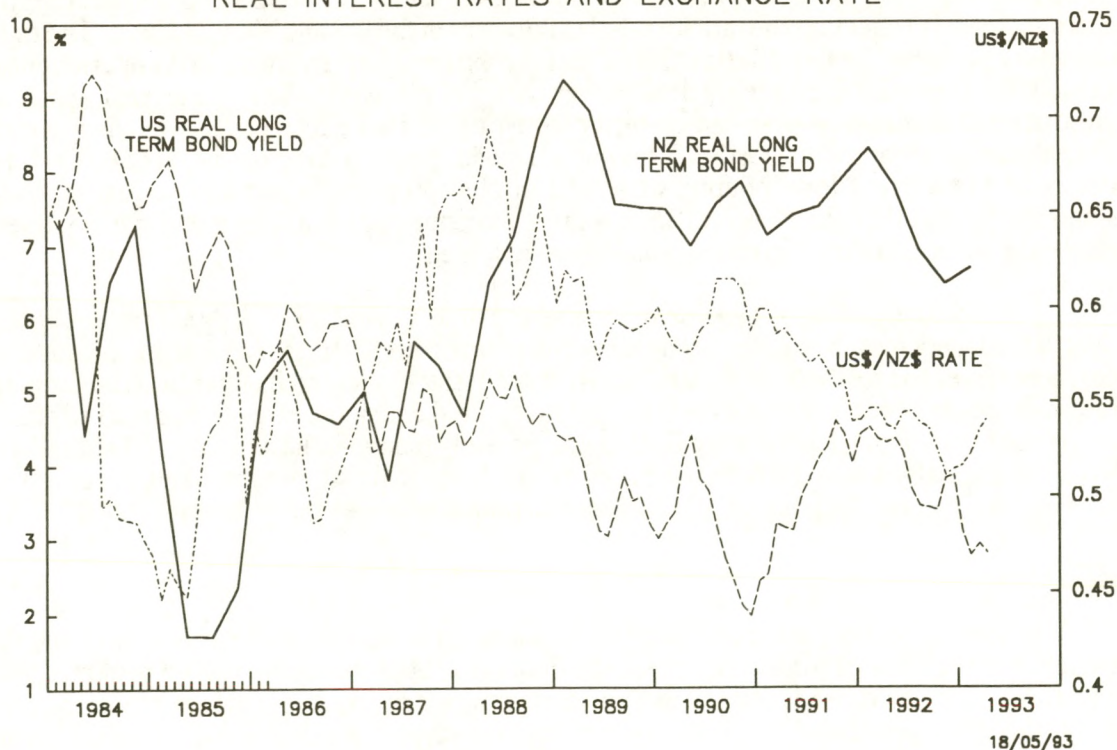
NEW ZEALAND: CHART 3
PREDICTED US\$/NZ\$ RATE AND REER INDEX OF NZ\$



NEW ZEALAND: CHART 4
INTEREST RATES AND THE YIELD SPREAD



NEW ZEALAND: CHART 5
REAL INTEREST RATES AND EXCHANGE RATE



Thanks to the sustained tight monetary control over the last five years, New Zealand now has one of the lowest annual inflation rates in the OECD group of economies (Chart 1). Movement in New Zealand's interest rates confirm this monetary picture (Chart 4). Both long and short rates tracked the rate of inflation as it declined over the 1980s. The negative yield spread which has existed for most of this time is a good indicator of the firm monetary hand exercised by the monetary authorities. Keeping short rates above long rates over time as occurred from 1987-91 instills disinflationary expectations in investors enabling nominal bond yields to fall. In 1991, when the economic downturn in New Zealand worsened, the yield spread turned positive. However, unlike nominal long yields, real long bond yields have not registered a consistent decline over the last 6 years as might be expected from the disinflationary monetary policy prevailing over most of this time. Instead they have fluctuated around 7-8% despite the deployment of an anti-inflationary policeman in 1989: the independent Reserve Bank. If New Zealand's real long bond yields are compared with those in the US, a clear differential between the two is visible from 1988 onwards (Chart 5). In addition to this, the nominal NZ\$/US\$ exchange rate has consistently depreciated throughout this time. It may be concluded that New Zealand's big corporations and governments had to pay approximately an extra 4% premium over US real bonds to attract investors who were expecting the NZ\$/US\$ exchange rate to further depreciate. It will now be shown that this depreciation should not be inflationary and has greatly enhanced New Zealand's longer term competitiveness.

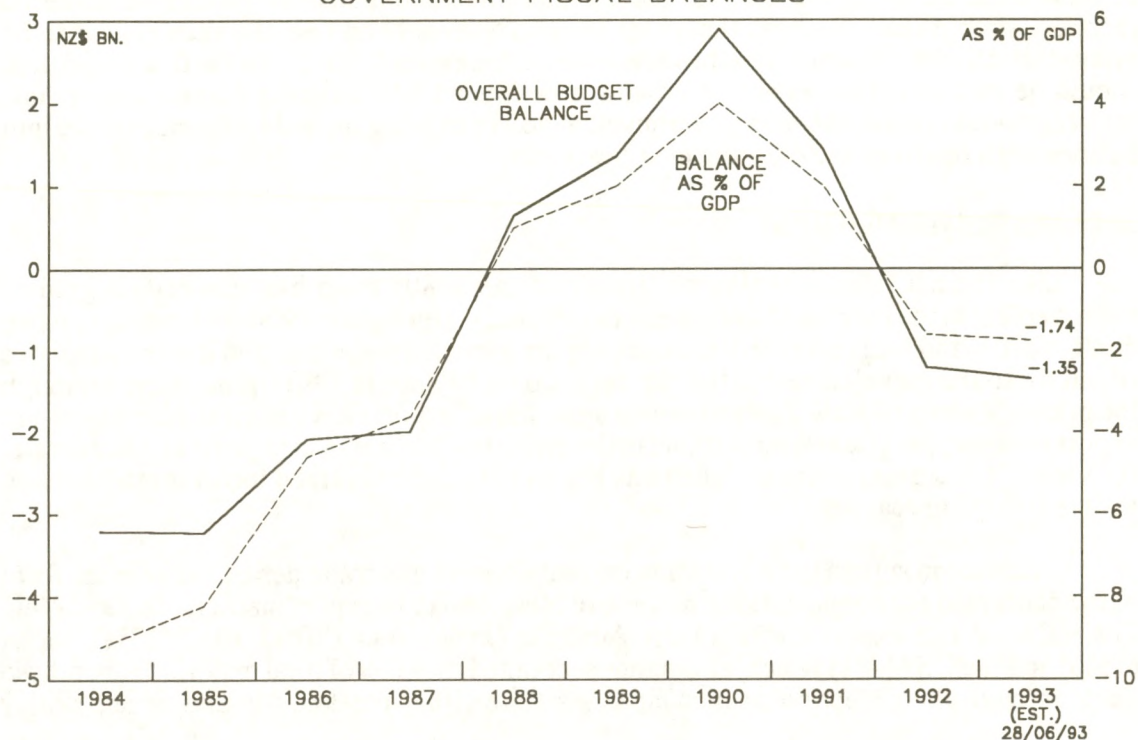
Chart 3 shows New Zealand's external competitiveness measured in two ways: first, using the bilateral NZ\$/US\$ rate and comparing it with changes in the NZ/US price differential, and second, using a real trade weighted exchange rate containing the basket of currencies of New Zealand's 8 major trading partners. On a bilateral basis the NZ\$/US\$ appreciated strongly in the mid to late 1980s following its floatation and subsequent devaluation in 1984. From 1987 to 1992 the then overvalued NZ\$/US\$ depreciated to rates more accurately reflecting the ratio of wholesale prices in the US and New Zealand. The tight monetary policy in the late 1980s ensured that the external improvement in competitiveness caused by the NZ\$/US\$ depreciation was not inflationary. The same real gains in international competitiveness can be observed from the real effective NZ\$ exchange rate. This declined throughout 1987-92 taking a similar path to that of the NZ\$/US\$ rate. Provided the current low inflation observed in New Zealand is not allowed to increase significantly and that the Reserve Bank retains monetary control, these real gains in New Zealand's external competitiveness should be sustained.

From the beginning of 1993 up to the present time, the NZ\$/US\$ appears to be slightly overvalued and may be under some downward pressure from a weakening balance of payments over the forthcoming year. The Reserve Bank has stated its intention to use short rates whenever necessary to prevent the trade weighted exchange rate -- a nominal effective exchange rate -- from depreciating further and possibly raising inflation. In 1993 short rates have occasionally been temporarily raised to do this. This support is likely to continue intermittently in the 2nd half of 1993 as the current account steadily deteriorates.

Funds Flow

When explaining past economic developments, it is sometimes helpful to examine the switches in the flow of funds position in the economy. Any economy can be broken down into three sectors whose income and expenditure positions must balance when calculated altogether. The private sector consists of savings and investment decisions, the public sector contains government expenditure and tax receipts and the external sector is characterised by

NEW ZEALAND: CHART 6
GOVERNMENT FISCAL BALANCES



the current account balance. The influence of the economic cycle will now be discussed with respect to the government sector, the current account balance and the private sector balances.

The Public Sector Balance

The net financial deficit is the difference between taxation receipts and government expenditure (Chart 2) whereas the overall budget deficit (Chart 6) consists of the financial balance with net asset proceeds added to it and debt repayments subtracted from it. Until 1991, both deficit measures had been narrowing more or less in tandem with the improvement in the current account balance (Chart 2). However, throughout 1990 and for most of 1991, New Zealand went through a recession (Chart 7) resulting in a 2% rise in the financial deficit measured as a percentage of GDP and as a result total public debt expanded by NZ\$3.1 bn to around NZ\$47.1 bn in 1992, 42% of which was external debt. Revised government estimates of the financial budget deficit depict no change over this fiscal year from 3.3% of GDP in 1991-92. A modest improvement in the financial balance can be expected over 1993 to 1994 as the private sector economic activity continues apace. Last year the overall budget deficit as a percentage of GDP was only 1.6%; less than the net financial budget deficit, due to the privatisation proceeds collected. This source of discretionary revenue is generally expected to continue over 1993 with the imminent floatation of New Zealand Rail, together with some electricity generating companies which are currently in government hands. Although some improvement in the public finances is expected over 1993, both deficits may only begin to significantly improve late in the next fiscal year 1993 to 1994, when the economic recovery will be stronger. As a result, sales of government debt through 1993 may be slightly less than those in 1992. The external portion of this debt will contribute to New Zealand's capital inflows and to any strengthening in the NZ\$ over this time.

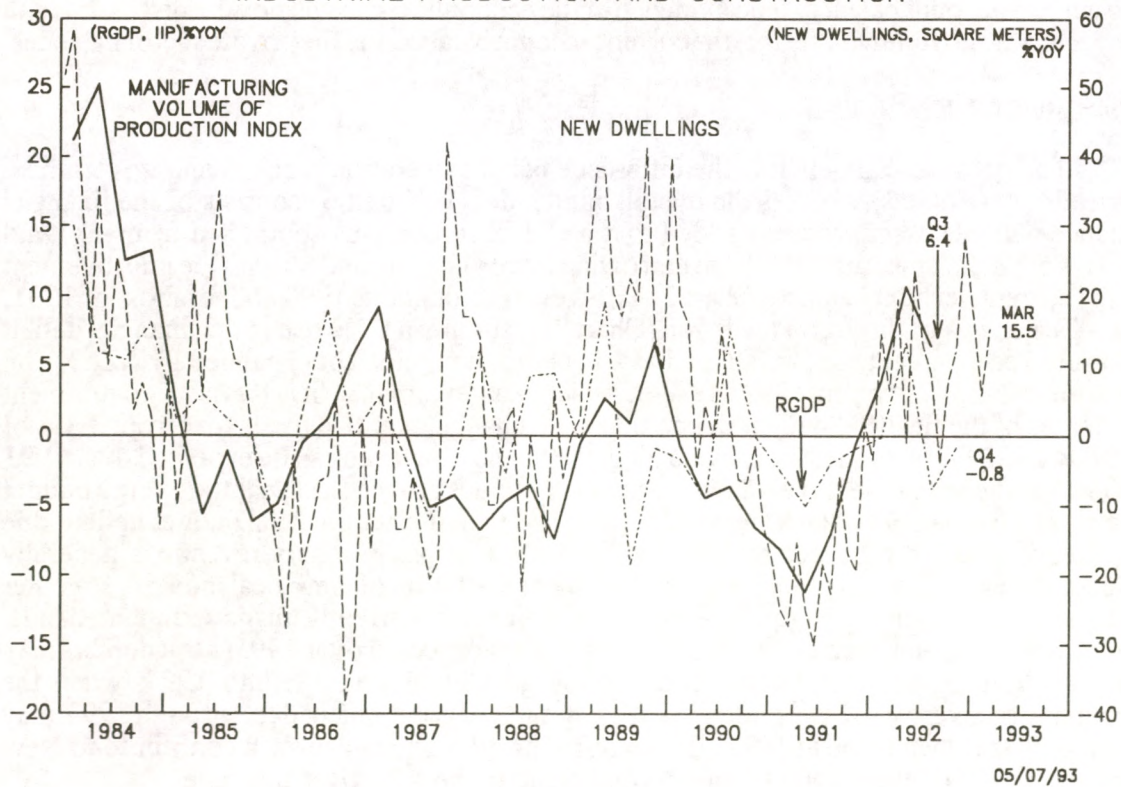
Although the forthcoming elections in autumn could signal an unexpected widening of these fiscal balances, the need for fiscal expansion will diminish as the current domestic recovery strengthens. As both the major parties: National and Labour, each appear to be sympathetic to the virtues of fiscal prudence the outlook over 1993-94 for the financial deficit should be one of improvement. Certainly a continued low inflation domestic economic recovery would enable the next government in power to bring the public finances more into balance with relative ease over the next few years.

The Current Account Balance

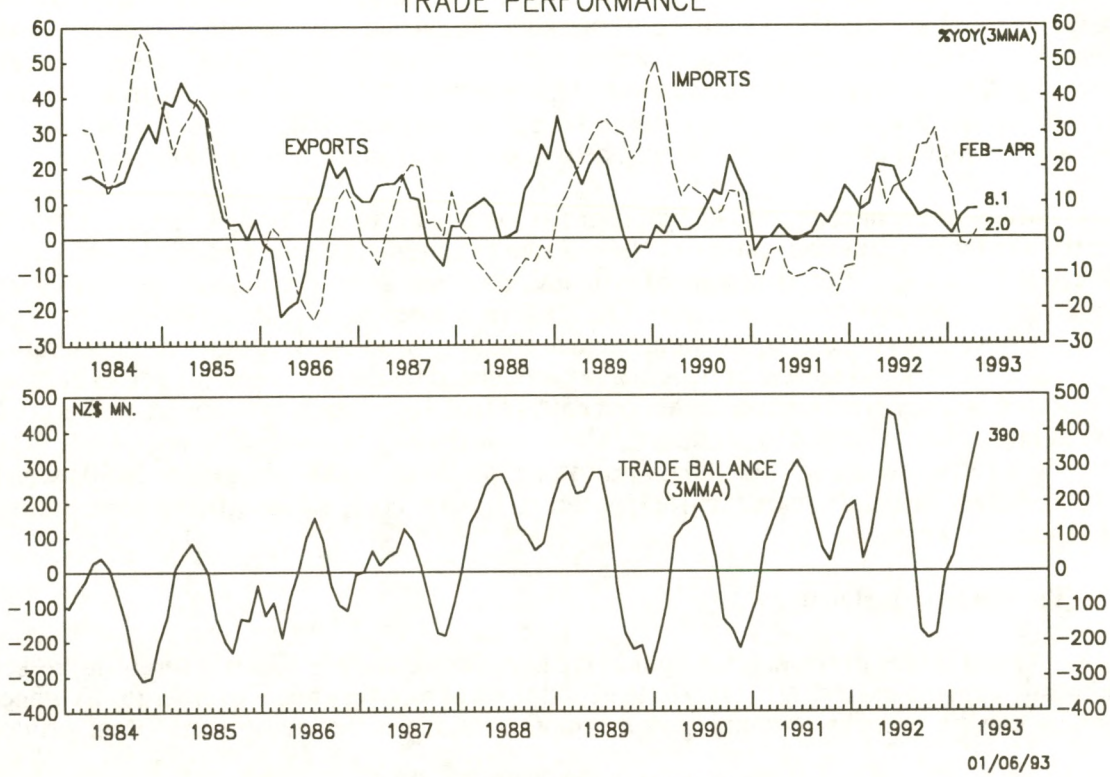
Like the net financial balance throughout the 1980s there has also been a gradual improvement in the current account balance (Chart 2). During the 1990-91 recession, when domestic demand was severely depressed, import growth decelerated and it was mainly this which led to the improvement in the current account balance in 1991. Since then, although the prices of some of New Zealand's main agricultural exports have risen (Chart 9), raising export revenue, the gradual turnaround in the economy has drawn in imports at a faster rate. As a result the current account deficit has begun to widen: this trend looks set to continue for the following reasons.

Evidence in support of a widening current account and trade deficit exists in the form of the depressed economic outlook in some of New Zealand's export markets. In 1992 New Zealand's top five export markets were Australia (20%), Asia (20%), EEC (17%), Japan (15%) and the US (14%) which, altogether accounted for 86% of total exports. All of these markets, with the exception of non-Japan Asia are either recession bound or are slowly

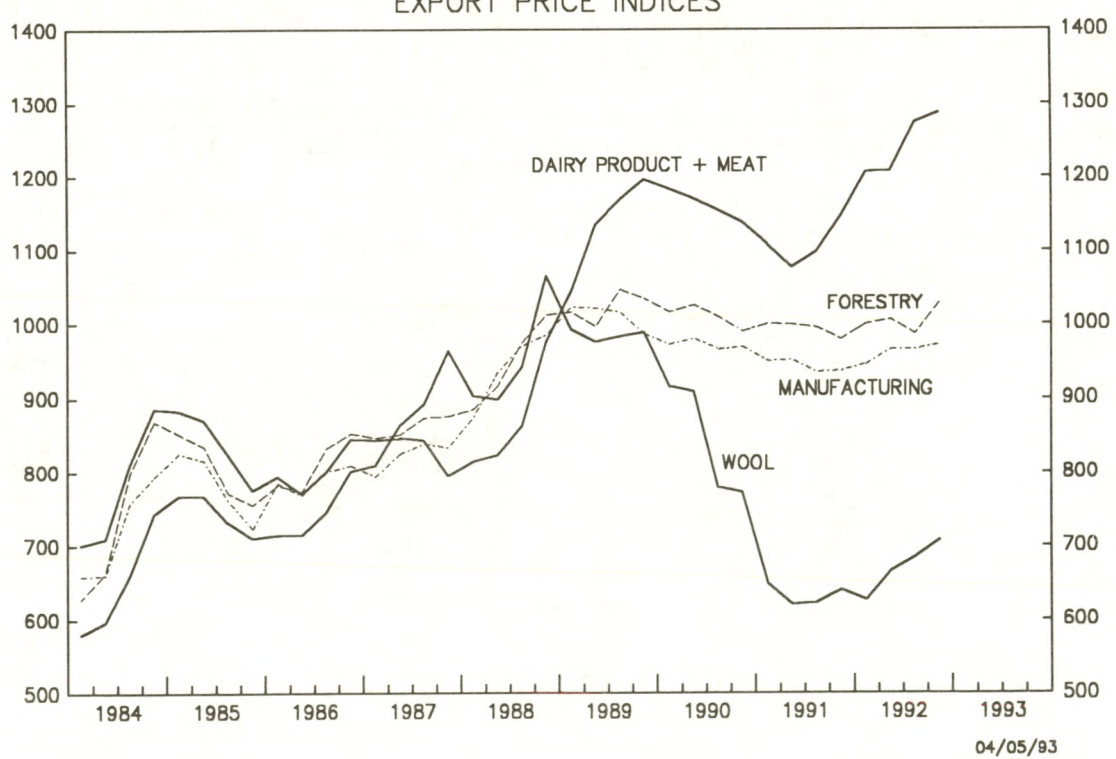
NEW ZEALAND: CHART 7
INDUSTRIAL PRODUCTION AND CONSTRUCTION



NEW ZEALAND: CHART 8 TRADE PERFORMANCE



NEW ZEALAND: CHART 9 EXPORT PRICE INDICES

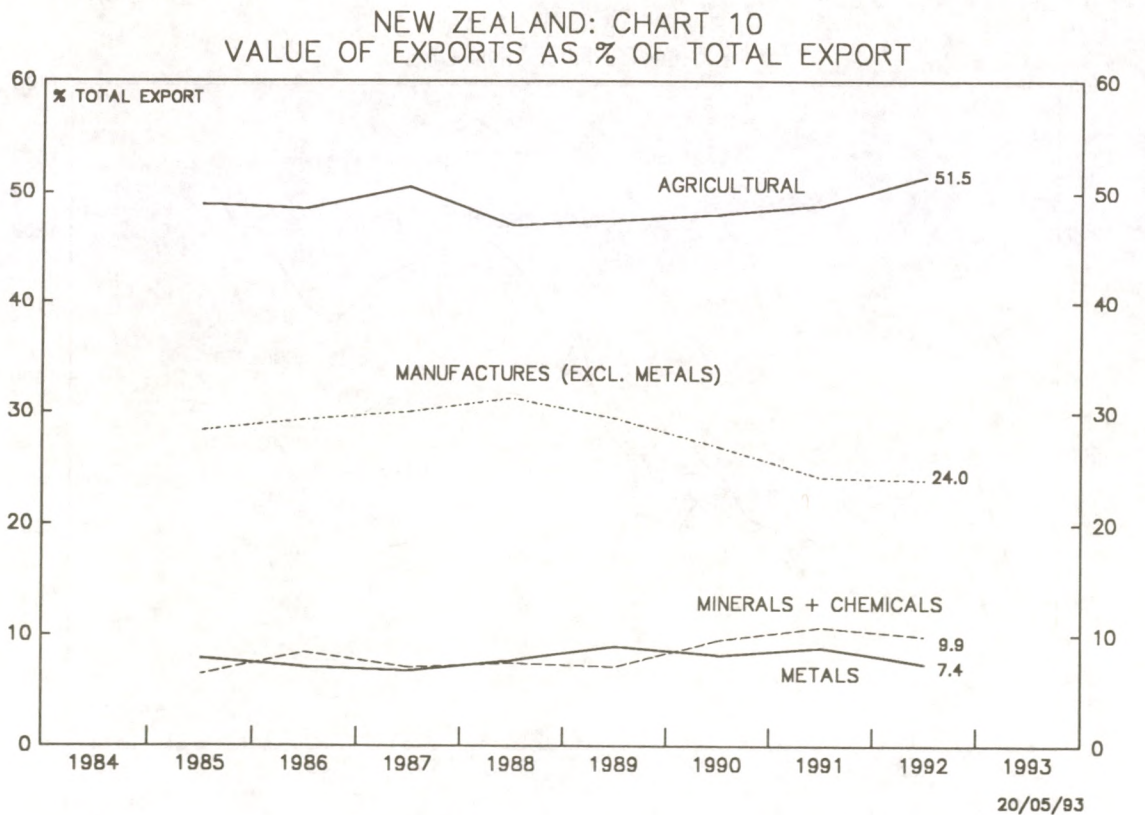


recovering from one. Although, as seen in Chart 1 in 1993, New Zealand's exports are more competitive than they have been for 5-6 years, this will only feed through to significantly higher export earnings if its major export markets experience a stronger upturn in aggregate demand. We think this unlikely for Japan and the EEC before the end of 1993. New Zealand's import growth is expected to accelerate and bring about a deterioration in the trade balance because as the economy's recovery strengthens, a recovery in GDP -- partially aided by the extra government expenditure -- would help draw in a greater quantity of imports.

Much of the acceleration in export growth which occurred during 1991-92 (Chart 8) can be attributed to the rise in some of New Zealand's commodity prices which occurred over this time (Chart 9). In particular dairy products, meat and wool experienced price rises and total export earnings rose as a result. This pattern is a repeat of that in 1984 and in 1988. In both these cases the current account balance was improved by export growth accelerating by over 20%. The value of exports is heavily influenced by these commodity prices because exports of primary produce account for over 50% of total exports (Chart 10). Manufactureds (including metals) share of total exports is less (31%) having fallen slightly since 1988. This may be a response to the trade liberalisation action taken in the mid to late 1980s which exposed New Zealand's manufacturing sector to greater competition forcing some rationalisation to take place.

The Private Sector Balance

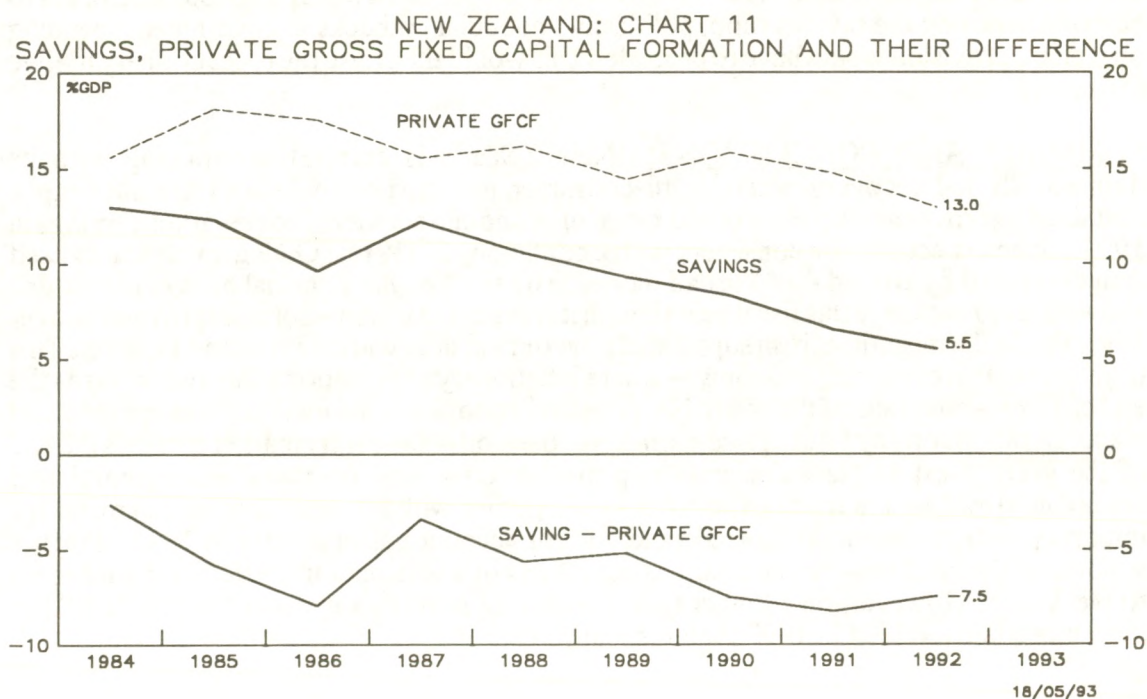
As mentioned previously the tight monetary policy in the late 1980s severely depressed domestic demand in 1990-91. Only in 1992 did signs of recovery begin to emerge. Evidence of this can be seen by examining consumption and private investment. Real private



consumption grew at a rate of 2% and real private investment at a rate of 3.5% in 1992 compared with -0.5% and -16% respectively in 1991. In the consumer sector, retail sales which were flat at around 0% yoy in 1991 have accelerated to over 7% through 1992-93. Evidence supporting an upturn in investment over 1992 is fairly widespread, however overall private investment has not yet recovered to its pre-recession levels (Chart 11). Manufacturing industrial production and the construction of new dwellings have shown consistent upswings over the past year. These have contributed to stronger real GDP growth of between 2-3% (Chart 7). Consistent with this upturn in investment is the fall in the unemployment rate which had reached a climax of around 11% by the end of 1991 and stood at 10.2% by the end of 1992. More significant declines in the current rate of unemployment can be expected with the forthcoming domestic economic expansion. One factor facilitating this is the 1991 Employment Contracts Act which abolished compulsory unionism and helped make pay setting procedures more competitive.

As previously mentioned the flow and switch in demand for funds within an economy can be analysed in the public, foreign and private sectors. Turning to the private sector, the savings-investment gap represents the excess demand for funds by households and corporations. Given that both foreign and public balances have recently been in deficit, that is, they had an excess demand for funds in 1991-92, the private sector balance should be in surplus at this time. Unfortunately as is the case here it is sometimes not possible to obtain or construct a fairly accurate independent measure of corporate savings, for use in this framework. The savings shown in Chart 11 are household savings only. However it can be deduced that corporate savings must have been around 12% of GDP for 1991 reflecting the rationalisation and restructuring which the recession imposed on New Zealand's industry at that time.

Households in aggregate save around 5.5% of GDP in New Zealand. This fairly low domestic savings ratio is partly a symptom of the relatively high share of GDP taken up by government spending (about 37% in 1992). Given the relatively high demand for funds by



the government during the recession, one way its spending could be financed without stoking inflation was by attracting foreign capital. This expansion in the external ownership of public debt, in effect augmented the private sector balance. The need for foreign borrowing would be reduced if New Zealand had a higher domestic household savings ratio, but households would only save more of their income if the government reduced its public expenditure (welfare provision). We will now discuss New Zealand's savings ratio in slightly more depth.

How Much to Save?

At present only about 5.5% of GDP is saved in New Zealand, which is higher than that in the US (around 4.5%), but low by Asian standards: Hong Kong (29%), Malaysia (27%), Thailand (30%).

Major differences in savings ratios across countries are partly explained by the different institutional structures in place which affect household motives for saving. One motive which accounts for a large part of households savings behaviour is that for retirement or precautionary purposes. Many countries have a state security system providing part or all of the funds necessary to support society's aged. In places where no effective state pension system exists, households have found it necessary to accumulate a higher stock of wealth than they would otherwise have done. This then provides them with an income when frailty, senility or otherwise prevents them from continuing to participate in the labour market. The larger the extent of public provision (possibly including health, disability allowances and maybe unemployment compensation) the less general need households feel to save for precautionary purposes. New Zealand, like Australia and Great Britain has a government managed state pension scheme, which forms part of a more extensive welfare state structure designed to insure households against certain economic misfortunes. In some parts of East Asia the level of state welfare provision is much smaller by comparison. This is one reason why New Zealand, along with Australia and Great Britain have lower savings ratios than those observed in some East Asian economies. It would seem that if a serious attempt is to be made in raising the savings ratio, politically unpopular cutbacks in government spending on welfare provision would have to be made. This would then raise the precautionary motive for saving.

SUMMARY AND CONCLUSIONS: New Zealand is currently continuing with its domestically led recovery where both consumer and corporate sectors are showing a sustained improvement across a broad range of economic activity. Stockmarket earnings in 1993 can be expected to be consistent with a continuing 2-3% real GDP growth which itself is underpinned by around 4-6% broad money growth. The net financial budget deficit will show little or no change this fiscal year though it is expected to show some improvement over 1993-94. In the meantime fresh supplies of government debt will enter the bond market. This together with a recovering economy -- where inflationary expectations may rise towards the end of 1993 -- could signal the end to New Zealand's buoyant bond market. This in turn could place limitations on any future price-earnings expansion in the equity market towards the end of the year. Despite New Zealand's improved international competitiveness, continued economic slowdown in many export markets together with a higher domestic demand for imports points to deteriorating trade and current account balances later in 1993. Further support of the NZ\$ may be necessary as the effects of a widening trade deficit would serve to weaken it. However, on a longer term purchasing power parity basis the NZ\$/US\$ has been more fairly valued in 1993 than for many years.

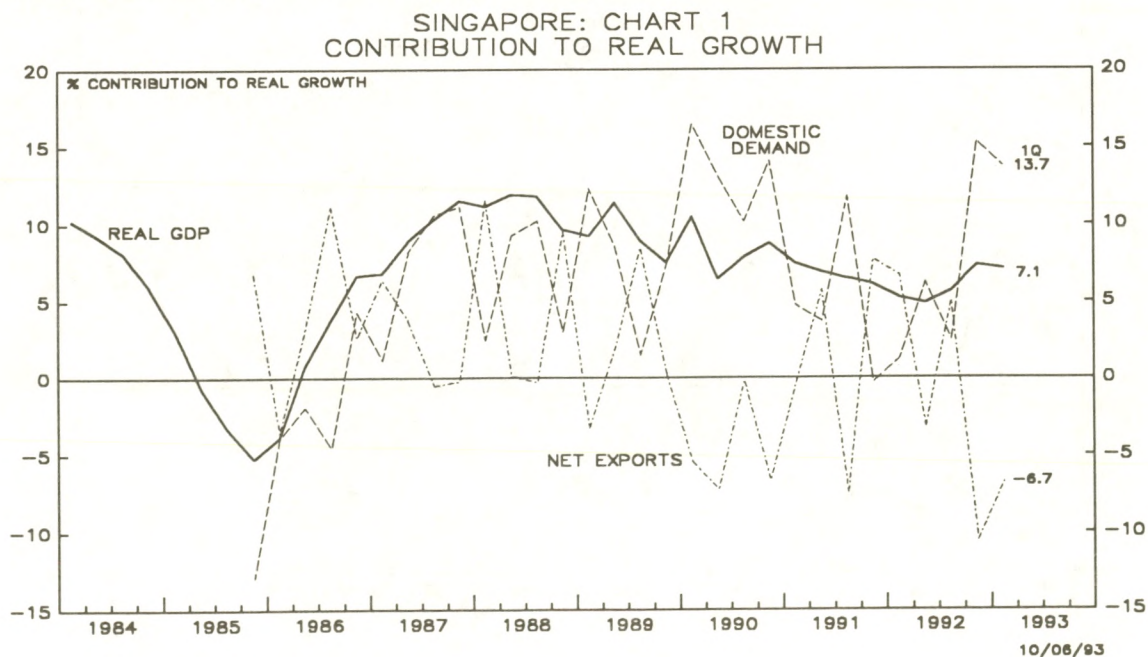
SINGAPORE RIDING THE CYCLICALS, ADDRESSING THE STRUCTURALS

Introduction

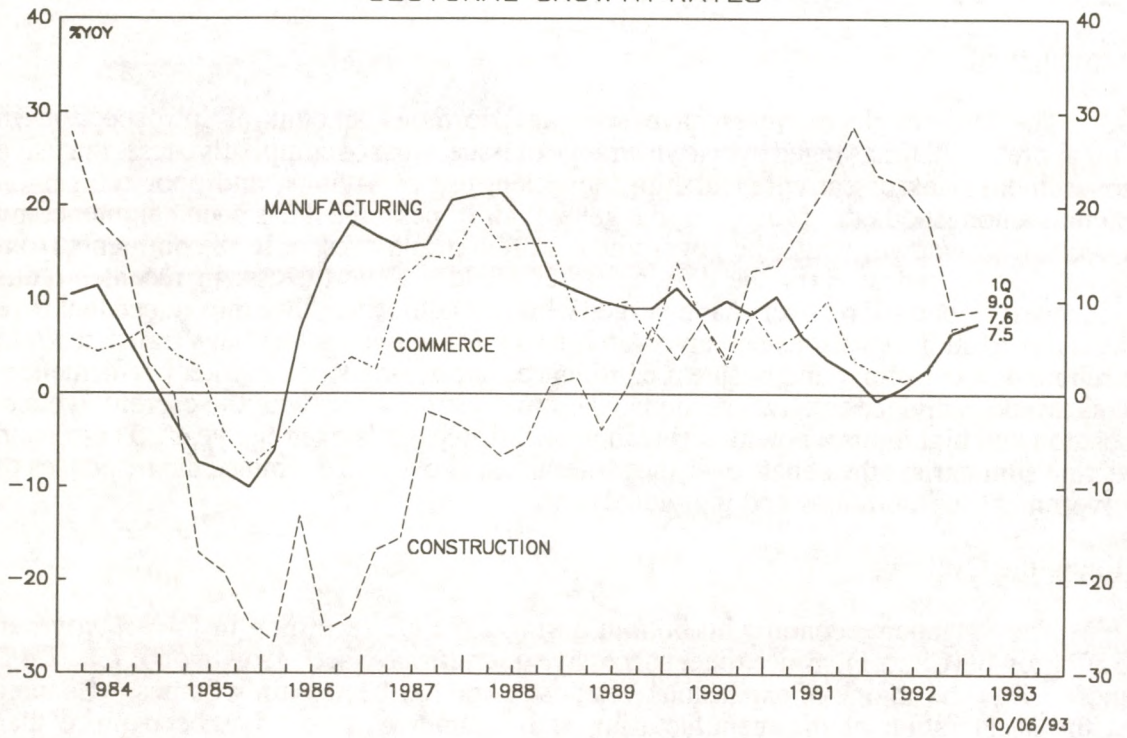
The last couple of years have seen an enormous amount of introspection in Singapore. Debate has raged over a wide range of issues: loss of competitiveness, intrusive government, lack of entrepreneurship, inefficient use of savings, and poor returns on capital, amongst others. Moreover, the general air of pessimism has been heightened by a cyclical slowdown, while the government's often prickly response to comments from abroad has helped to carry the debate further afield. Nevertheless, in recent months evidence of economic recovery has emerged while the authorities have introduced tentative measures to address various perceived problems. These two factors have translated into a rebound in consumer and business confidence, and strong stock market performance. This article is divided into two sections. The first section deals with the current cyclical position and highlights a potential risk to growth forecasts later in the year. The second section summarises the debate over the issues listed above and examines the responses of government, corporations and individuals.

Riding the Cyclical

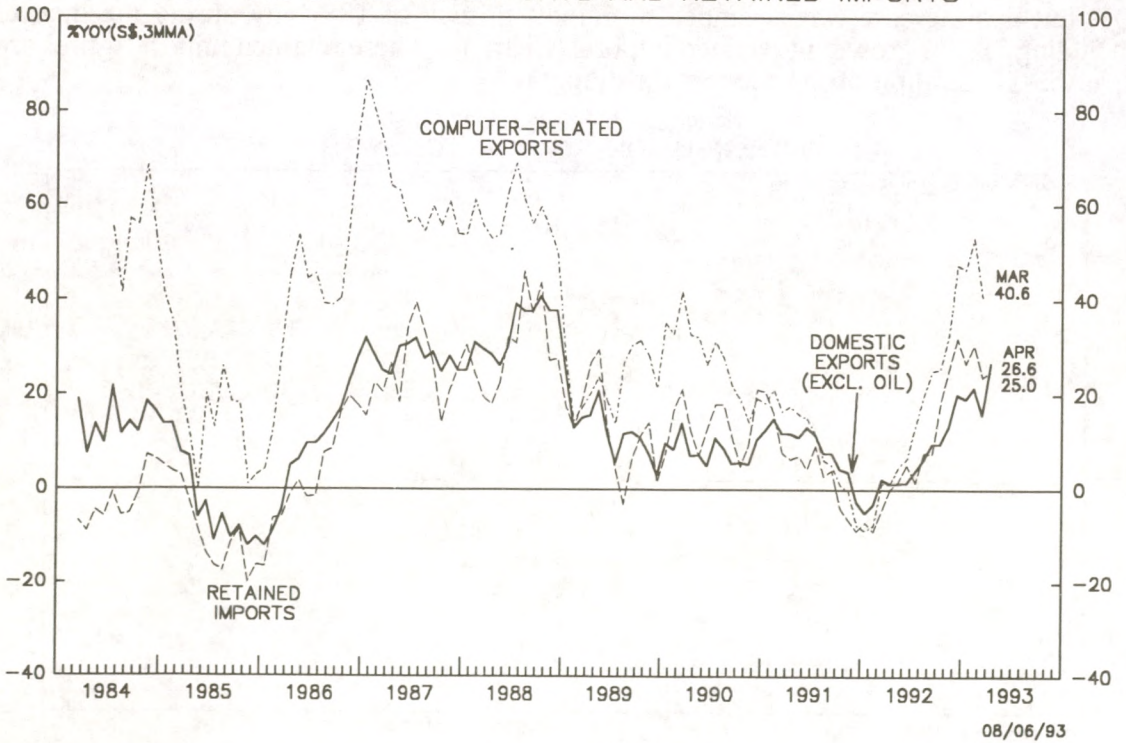
The Singapore economy hit bottom during 1992 Q2 recording just 4.9% yoy real GDP growth (Chart 1). Since then, successive quarters have seen growth of 5.7%, 7.4% and 7.1%. The engine of expansion over this period has been mainly domestic demand as the acceleration of the manufacturing and commerce sectors has been more than sufficient to offset the (relative) slowdown in the construction sector (Chart 2). Net exports, by contrast, have tended to subtract from GDP growth over the period despite a strong performance from merchandise exports. Exports increased 13% yoy during 1993 Q1, but this increase was swamped by import growth of 18% yoy during the quarter including 23.8% growth in retained imports (Chart 3). These retained import figures are a further illustration of the economy's strength.



SINGAPORE: CHART 2
SECTORAL GROWTH RATES

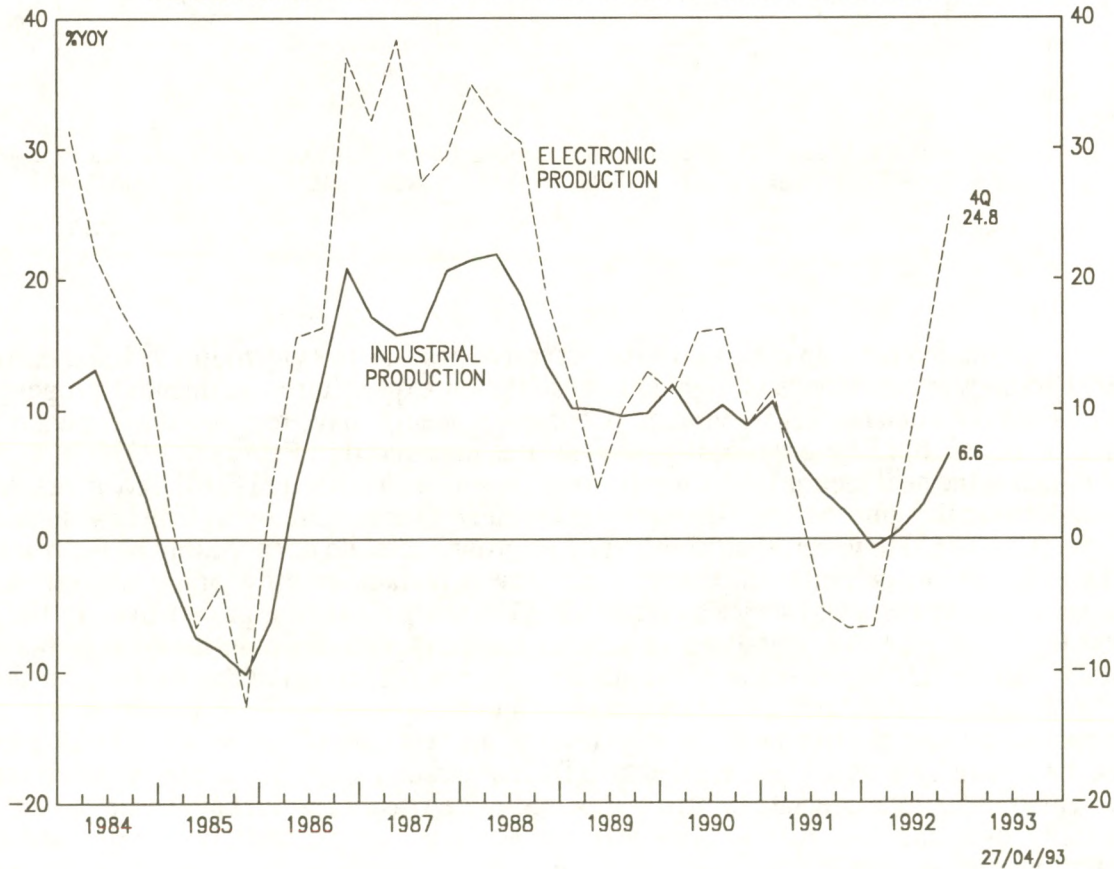


SINGAPORE: CHART 3
NON-OIL DOMESTIC EXPORTS AND RETAINED IMPORTS

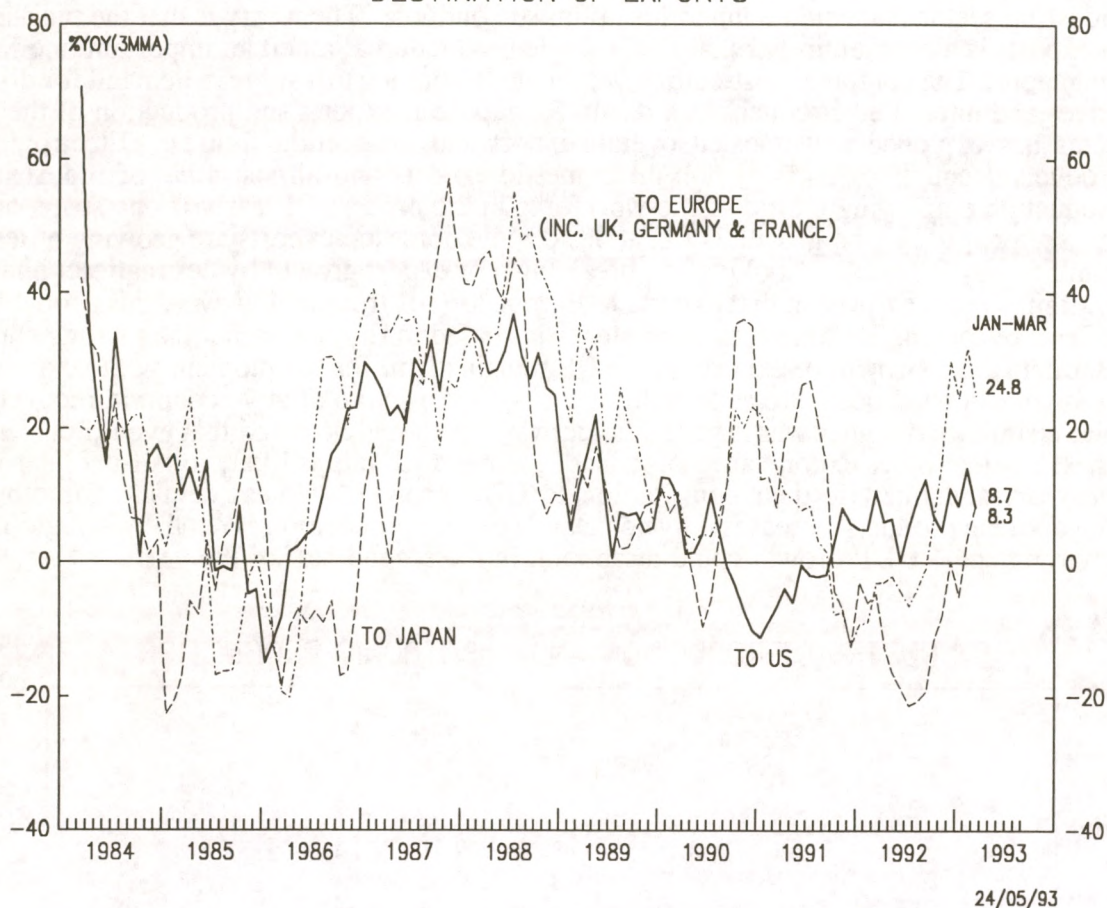


On the face of it, therefore, Singapore seems set for a healthy economic performance over the course of this year. Nevertheless, the broad GDP figures mask trends in the industrial sector that could temper this optimistic outlook. The worry is that the pick-up in exports is almost entirely reliant on a single product area, albeit an important one for Singapore. The computer cost-cutting war in the US has led to a surge in demand for disk drives and integrated circuits. As a result, Singaporean exports and production of these items has exploded and boosted overall export and production figures. Electronics products account for 37% of non-oil domestic exports and almost 40% of industrial production employing a third of the workforce in the process. Clearly if one strips out this sector, production growth is flat at best, while domestic exports are growing at less than 5% yoy (Chart 4). Looking at a breakdown of export growth by destination (Chart 5), it may seem surprising that exports to Europe are so strong. However, this probably reflects restocking by American computer firms based in Europe, rather than strong end-user demand. Growth of exports to the US remains firm for the moment while exports to Japan can be expected to accelerate further -- irrespective of any economic recovery -- as a similar computer war is getting underway. It should be noted that even if current levels of electronics exports are maintained, their growth rate is likely to tail-off later in the year, and likewise their contribution to GDP growth. Unless demand for other Singaporean products increases -- by no means a certain proposition given the weak global environment -- GDP growth could disappoint in the second half of the year.

SINGAPORE: CHART 4
INDUSTRIAL PRODUCTION AND ELECTRONIC PRODUCTION



SINGAPORE: CHART 5
DESTINATION OF EXPORTS

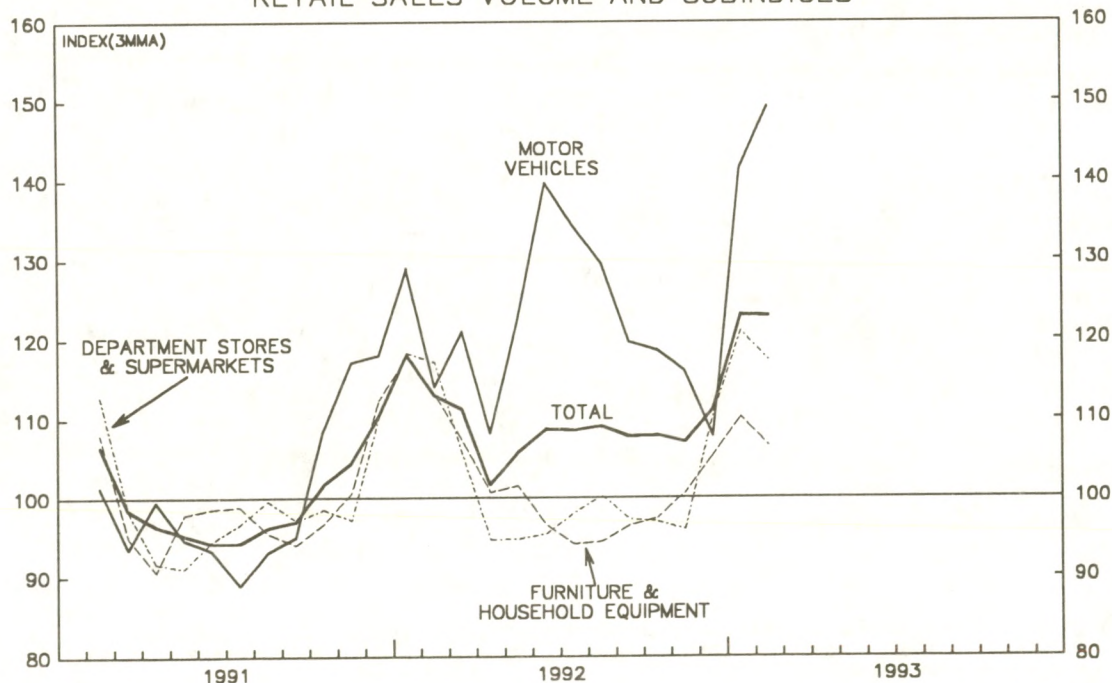


For the moment, in contrast to the pervasive pessimism evident in 1991 and early 1992, domestic confidence is high and consumption expenditures, residential property prices and the stock market are vibrant. Consumers seem to have responded to the export pick-up (Chart 6) and more recently, to measures introduced in February 1993's budget (outlined in the next section). The newly-found optimism has not translated into increased loan demand though. M2 and loan growth continue to slow and are now below double digits (Chart 7). However, their continued low growth rates do not appear to be the result of supply side constraints. Monetary base growth remains healthy which suggests an accommodative monetary stance by the MAS. (The sharp dip in base growth in early 1992 was the result of MAS operations to support the Singapore dollar in the face of rapid Malaysian ringgit appreciation. The decision by the Malaysian authorities to cap the ringgit's rise around April 1992 brought an end to this policy.) This proposition also is supported by both the trend and absolute level of interest rates (Chart 9). The MAS uses the exchange rate as its principal anti-inflation weapon allowing the nominal trade weighted index to appreciate to offset imported price rises. The exchange rate basket's stability over the last year implies that the MAS is not particularly worried about inflationary pressures at the current time, but is more concerned to nurture the recovery underway.

An accommodative MAS is potentially complemented by a cash-rich banking sector sitting on extremely strong balance sheets. Capital-adequacy ratios exceed comfortably the MAS requirement of 12% (let alone the 8% BIS target) averaging 14-15% for the industry as a whole, and 18.5% for the 4 major players. Loan-deposit ratios stand at only 88% and the statutory liquidity requirement (18% of total assets must be held in liquid assets -- cash, government bonds, etc.) is also easily met. The potential for loan book expansion is therefore clear. Nevertheless, it has been a fall in the demand for money that has been responsible for slow asset growth, and this demand has yet to pick up in line with greater expenditures. Two explanations can be offered. First, savings rates in Singapore are incredibly high -- 47% of 1992 GDP on a national accounts basis -- so current expenditures at both a corporate and consumer level are being financed from accumulated balances. Second, electronics exporters have smaller financing requirements than exporters of say oil rigs or machinery and transport equipment. Without recovery in these sectors, a significant loan growth acceleration is unlikely.

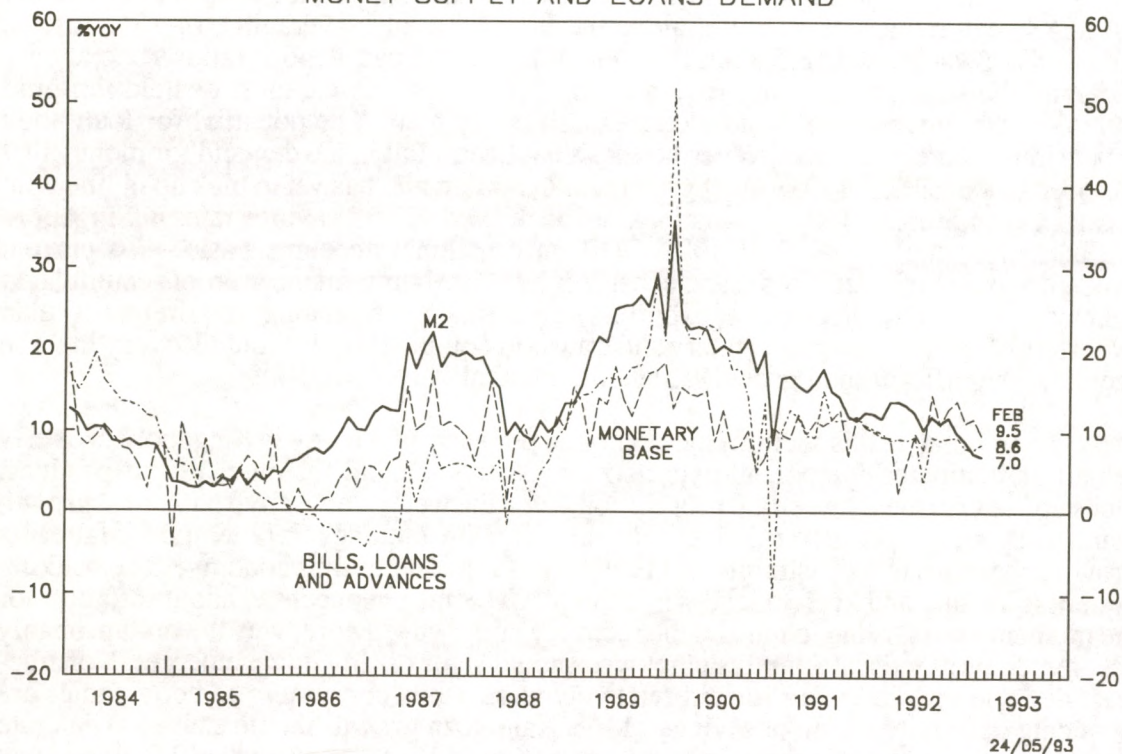
To summarise this section, the economic recovery underway in Singapore is overly reliant on computer component exports. Unless the demand for other export products picks up -- by no means a certain proposition given the weak global environment -- growth could disappoint in the second half of the year. Notwithstanding this potential for faltering growth, there are few constraints on the supply of liquidity to the economy. The banking system is healthy and keen to lend while the MAS seems unconcerned about inflation for the moment and is trying to nurture the recovery underway. Moreover, it would probably accommodate any fiscal stimulus employed should signs of slowdown emerge. Nonetheless, demand for credit will remain relatively weak while consumers and companies are financing expenditures out of savings. Money and loan growth should start to accelerate gently in the next few months, possibly incentivised by a further cut in lending rates. However, a sharper upturn will only accompany a broader-based recovery.

SINGAPORE: CHART 6
RETAIL SALES VOLUME AND SUBINDICES

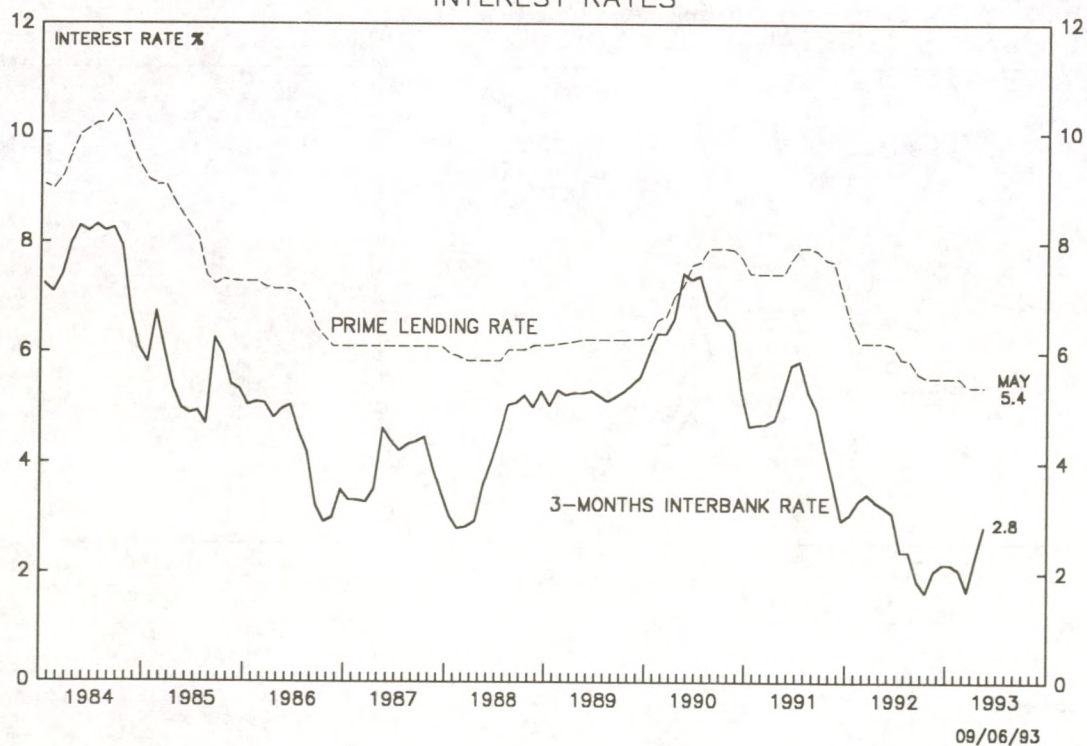


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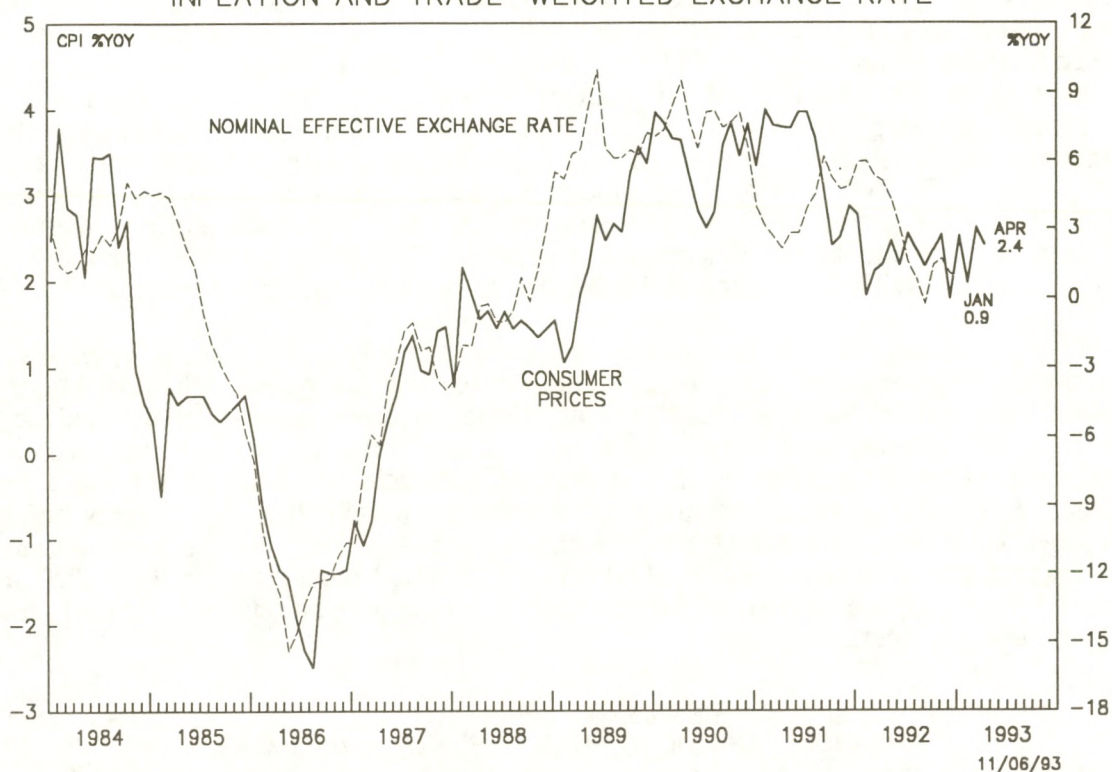
SINGAPORE: CHART 7
MONEY SUPPLY AND LOANS DEMAND



SINGAPORE: CHART 8
INTEREST RATES



SINGAPORE: CHART 9
INFLATION AND TRADE-WEIGHTED EXCHANGE RATE



Addressing the Structural

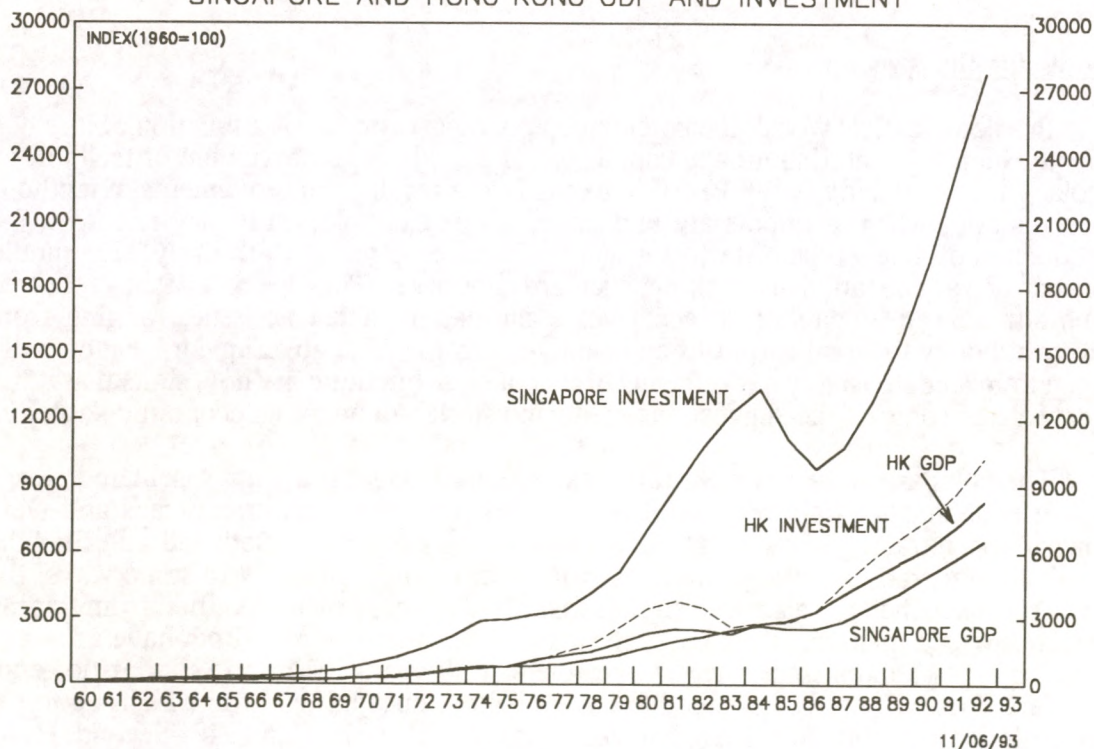
In a neo-classical world, the potential output of an economy is a function of its stock of factor inputs -- land, labour and capital -- and the rate of improvement of technology or total factor productivity (TFP). TFP expands as a result of improvements in methods of production, when all inputs are unchanged. For example, TFP may rise with the introduction of a new type of fertiliser that increases crop yields. Similarly TFP should also increase as education and training standards improve. The idea of TFP has received much attention in Singapore in recent years and has impacted on issues ranging from industrial policy to fiscal surpluses and captive savings. The government has generally tended to react defensively to criticisms of its policies, but there are now signs that it has taken note of some of the suggestions made and started to adapt its economic strategy.

The comparison between Singapore and Hong Kong has always fascinated development economists. In 1960, the territories had similar per capita incomes and were primarily open trading ports with little manufacturing capability. Both had inherited the British administrative and legal systems from their colonial master. In some ways, the path taken since then has also been similar as the two economies have shifted from trading ports to low-end manufacturing bases to financial services centres. Both have grown at around 6% per annum in real terms over the last 30 years. Here the similarities end, however. First, Hong Kong tended to have a better educated workforce right up to the late 1980s due to the influx of Shanghainese refugees from the PRC in 1949. Second, Hong Kong's administrators have kept intervention to a minimum allowing the world's most laissez-faire economy to flourish. Singapore's governments, by contrast, have played a leading role in economic development.

In early 1992, a paper by Alwyn Young of Massachusetts Institute of Technology* argued that Singapore's growth had been a function of increased accumulation of capital stock rather than TFP growth. He noted that by the late 1980s, Singapore was investing twice as much as a percentage of GDP as Hong Kong, yet its growth rate was the same (Charts 10 and 11). Because labour productivity was increasing at similar rates in both territories, the implication was that Singapore's incremental capital-output ratio (the amount of capital needed to produce an extra unit of output) was twice that of Hong Kong. Moreover, while 56% of Hong Kong's incremental output per worker could be attributed to TFP over the period 1970-90, TFP actually fell 6% in Singapore during this time. Finally, Mr. Young claimed that returns on capital in Singapore had fallen from 40% in 1960 to only 11-12% by the end of the 1980s, one of the lowest rates in the world.

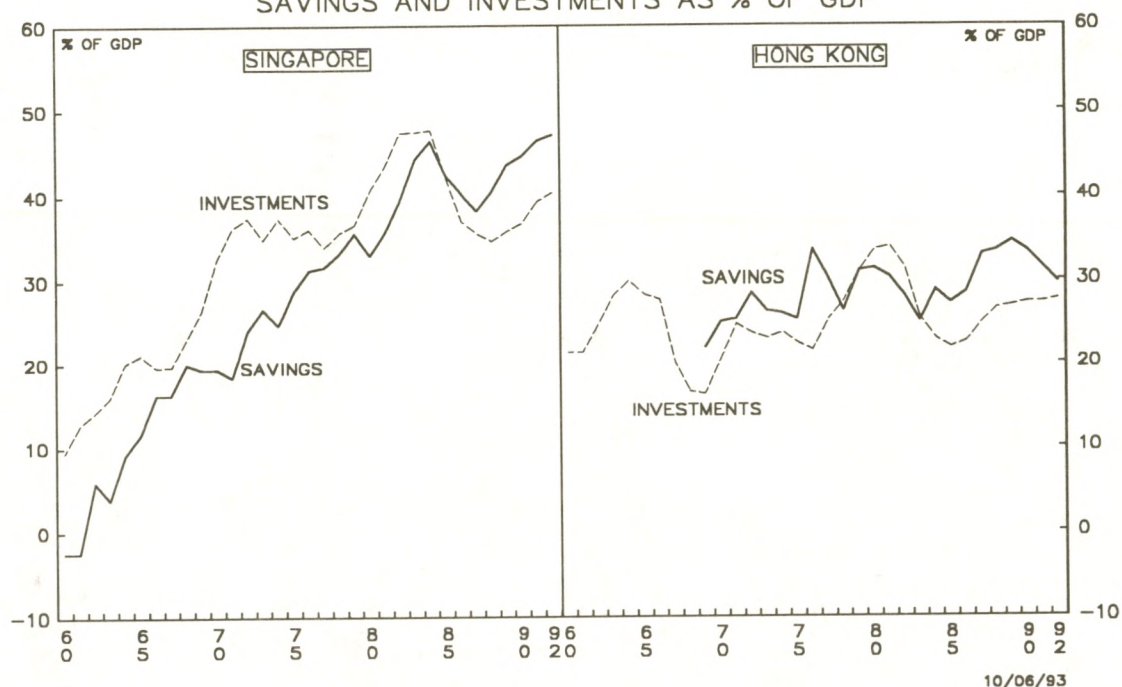
Mr. Young puts the blame for these phenomena firmly on the industrial policies of the Singapore government. Over time, the authorities have compelled high rates of saving via the Central Provident Fund (CPF) and large fiscal surpluses, and have channelled these savings into investment in target industries, and into direct investment incentives for multinationals. Singapore has indeed become successful in many of the industries targeted, but the problem appears to be a tendency to switch to new targets before production efficiencies resulting from experience can be exploited. Furthermore, because savings rates are now so high (47% of GDP in 1992), Mr. Young argues that it is difficult to see how Singapore can extract further funds from the population to enable it to grow along these old lines.

SINGAPORE: CHART 10
SINGAPORE AND HONG KONG GDP AND INVESTMENT



* A tale of two cities: Factor accumulation and technical change in Hong Kong and Singapore.

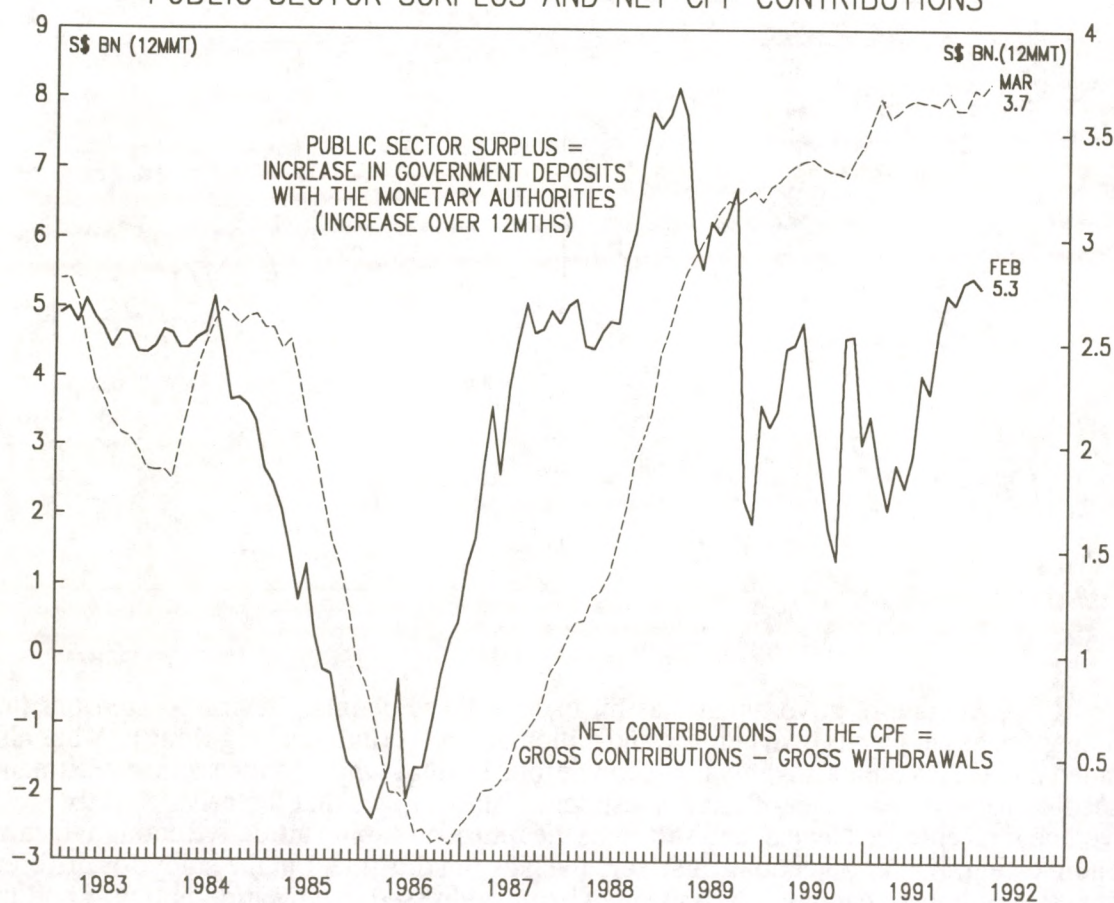
SINGAPORE: CHART 11
SAVINGS AND INVESTMENTS AS % OF GDP



The Singapore government has hit back at these claims. It has pointed out that Singapore has to pay its own defence and diplomacy costs (unlike Hong Kong). It has also noted that CPF savings are only one-sixth of total savings while public sector investments account for only one-fifth of total investment. This implies that the private sector saves well beyond enforced levels, and still finds the return on capital attractive enough to carry on investing. Other objections raised are the lack of adjustment in the study for different qualities of human capital -- an issue now being addressed in education policy -- and the benefits of Singapore's superior infrastructure which are not captured fully in the national income accounts. Some of these counter-claims have more validity than others. Certainly, the argument highlighting the unquantified "quality of life" benefits of better infrastructure appeals to this Hong Kong resident, although in theory, national account statistics are supposed to measure flows of income accruing from housing and roads. In the case of private ownership, implicit rental income is imputed. Nevertheless, compare the two territories' airports or ask a Hong Kong public housing occupant whether he would like to purchase a flat three times the size of his current one for the same amount of money, and the attractions of Singapore are clear.

Ultimately though, it is difficult for Singapore to fully refute Mr. Young's findings, and to its credit, the government has introduced a number of measures in recent times to encourage freer deployment of private savings. The latest budget announced in February (see AMM Vol. 17 No. 2) sets out to cut the fiscal surplus from 5.7% of GDP in the year to March 1993 to 2.5% of GDP this year. This is to be achieved in part by cuts in personal and corporate income tax and CPF contribution rates, and in part by increased government spending. Although the fiscal expansion is relatively conservative (as one might expect), it will mean the rate of accumulation of government deposits at the MAS will fall thus freeing up further resources for the private sector (Chart 12). Of more long term importance though, are measures introduced to liberalise CPF fund usage (to be enacted in September 1993), and to incentivise overseas investment.

SINGAPORE: CHART 12
PUBLIC SECTOR SURPLUS AND NET CPF CONTRIBUTIONS



09/06/93

Turning to the CPF first, Chart 12 shows how net contributions have been rising in recent years as Singaporeans have shunned (or have been denied) the opportunity to invest their CPF funds in equities and residential property. Under the new rules introduced, the amount of CPF funds available for investment has been doubled to 80% of gross savings in excess of a minimum level, the range of investible instruments has been widened, capital gains and dividends can now be withdrawn at any age (55 previously), and property purchase limits have been raised. There are signs that use of funds for equity purchases is already rising (7,000 new CPF equity accounts were opened in March 1993, for example) and this bodes well for the government's large scale privatisation plans (notably Singapore Telecom towards the end of this year). In addition, the raising of property purchase limits implies that more funds should be attracted into private sector housing as opposed to properties offered by the Housing and Development Board (HDB). This boosts liquidity, other things being equal, as the HDB is a statutory board and as a public body, holds most of its funds at the MAS. It has been calculated that the measures introduced potentially make available an extra S\$8 billion for investment on top of the current investible pool of S\$14 billion. However, it should be noted that to date only around 15% of the pool had been actually drawn down. It remains to be seen if the measures will ultimately be successful in stimulating alternative savings patterns.

Similarly, it remains to be seen if tax incentives introduced will stimulate overseas investment. The government has noted (somewhat wistfully) that it does not have the equivalent of Hong Kong's southern China hinterland just across its borders. Lack of cultural affinity with Malaysia and Indonesia may well have hampered attempts to create growth triangles and shift low cost manufacturing production overseas. However, one often hears the complaint in Singapore that the guiding hand of government has eliminated the Chinese entrepreneurial spirit by creating such a low-risk domestic environment. Such propositions are impossible to prove or disprove (and are certainly beyond the scope of AMM) but it may be some time before Singapore investment behaviour abroad matches that of the rest of the Chinese diaspora.

In conclusion, the Singapore government has started to relax its grip on the economy's resources, and one can expect further measures in the coming years to encourage more entrepreneurial saving and investment decisions. It is unrealistic to expect Singapore to become another Hong Kong overnight (or indeed ever). However, the apparent willingness of the government to address the economy's structural problems, should help to underpin the cyclical recovery underway, and long term, should ensure that the Lion City continues to enjoy the benefits of rapid economic growth.

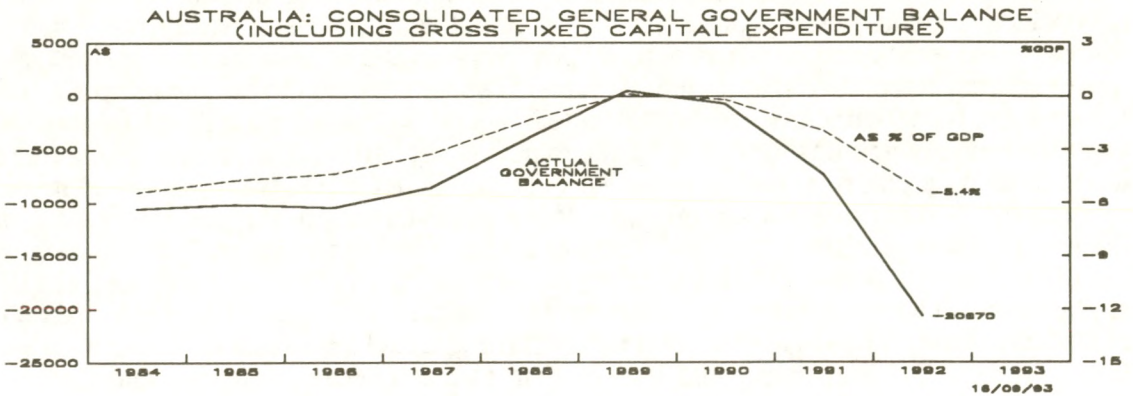
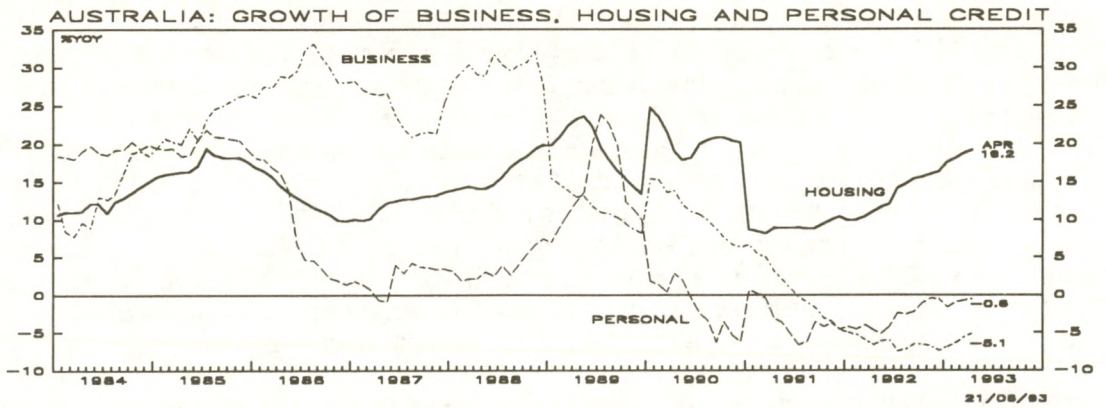
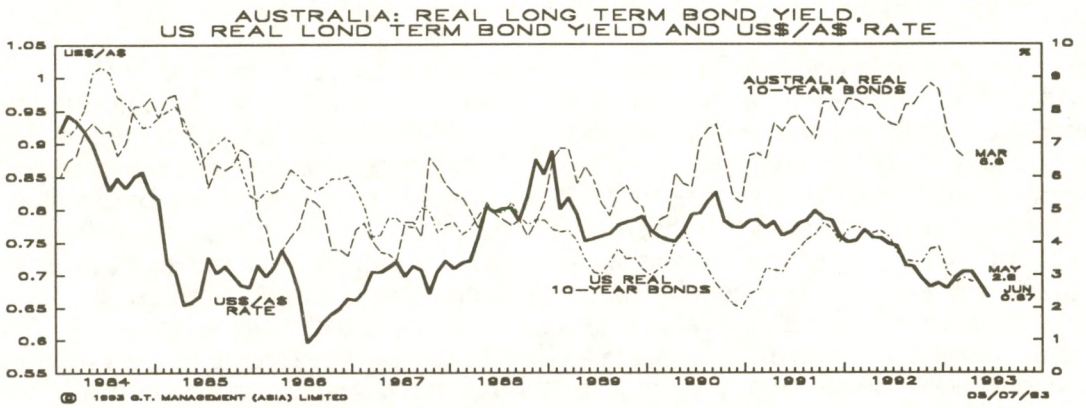
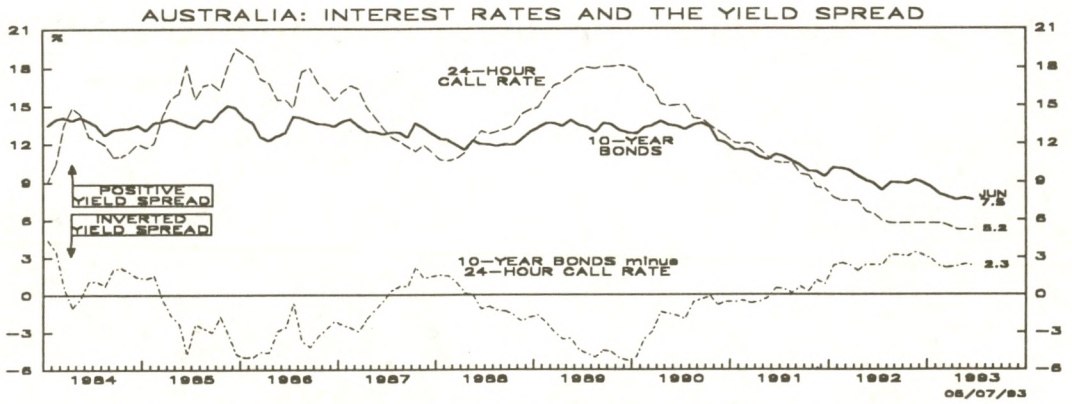
AUSTRALIA: FACTORS PREVENTING FURTHER FALLS IN AUSTRALIAN LONG BOND YIELDS

Since 1990 there has been a downward trend in both long and short Australian nominal interest rates. Back in 1989-90, when the yield spread was around -5% the environment created was one of disinflationary expectations. The deceleration in broad money growth and credit that ensued landed Australia in a recession which it is currently only beginning to recover from. This recession brought about a deterioration in the consolidated budget deficit over 1990-1992 which kept real long rates relatively high until mid-1992. Since then they have declined by 2-3%. From mid-1991 onwards the yield spread turned positive. However, this has not led to a strong recovery. High levels of corporate indebtedness caused by the collapse of the previous credit boom underlie the low current monetary and credit growth.

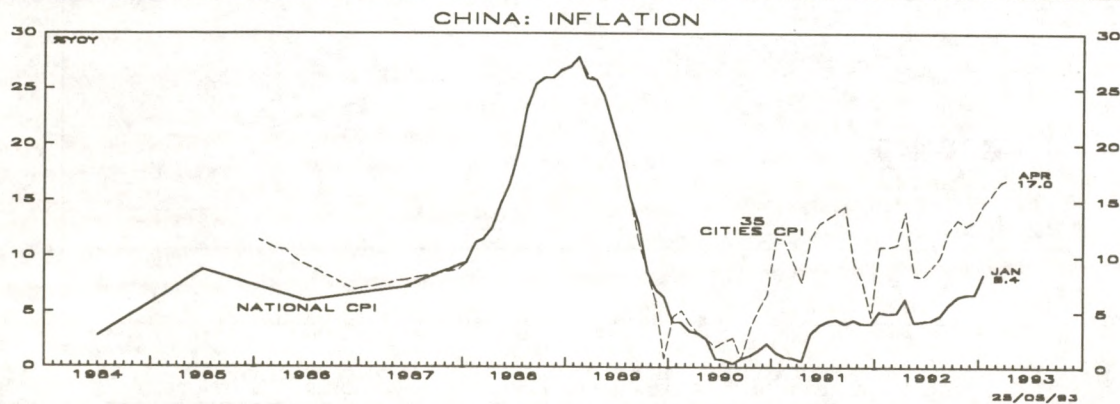
Whether or not Australian nominal and real long bond yields are able to continue on their downward path and help stimulate further recovery depends on three factors. The first is the expectation of higher Australian inflation (currently at 1.2%) as recovery progresses. Expectations of future inflation may be influenced by the yield spread (short rates relative to long rates) and by current monetary growth. Although, as already indicated, the yield spread has been positive since mid-1991 (currently around 2.3%) non-housing credit and broad money growth are still low. The latter accelerated slightly to 2.6% in April from 1.7% in January. As inflation is still low there may be room for further cuts in short rates without stoking the inflationary firebox. However further weakness in RBA commodity prices -- possibly as a result of slow global economic growth -- would lead to reduced export revenues and a deteriorating current account balance. This in turn could weaken the A\$/US\$ and, if the Reserve Bank continued to support it delays will result in any future easing of short rates. In addition, prolonged downward pressure on the A\$/US\$ may stall further gains in the bond market.

The second factor preventing Australian real and nominal long bonds from declining much further this year is the extent to which US long yields can fall further. From 1990 onwards US 10 year real and nominal bond yields have followed a downward course. Whilst Australian nominal yields have followed suit, real yields remained relatively high and have only shown marked decline since mid-1992. The scope for further declines in Australian nominal long yields is then partly reliant on how much further their US equivalents fall. US long bond yields are affected by the expected inflation rate in the US and by the financing of the federal deficit. Despite a (10 year bond-3 months bill) yield spread of 2.8% in the US, continued slow broad money growth of up to 4% (yoy) by the end of this year would, we think, keep US inflation roughly flat for the rest of 1993. The absence of further declines in inflation could signal some future weakening in the US bond market. However, this would be offset, to some extent, by any unexpected narrowing of the Federal deficit and decline in US net debt outstanding. We expect US nominal long rates to remain roughly at current rates (at around 6.4%) until the end of 1993. Given this, the outlook on this basis for Australian nominal long yields is for a slowdown or halt in their decline.

A third reason to suspect that Australian long bond yields may soon reach a floor and begin to firm is the further widening of the domestic public deficits. Official indications of the Commonwealth deficit (the most significant component of the Consolidated deficit) point to, at best, no change in the deficit over 1993-94 and possibly a worsening. This being the case, pressure on nominal Australian long rates is likely to be upward over the latter part of 1993 and for the start of 1994.



CHINA: THE TIGHTENING BEGINS BUT MUCH MORE IS NEEDED

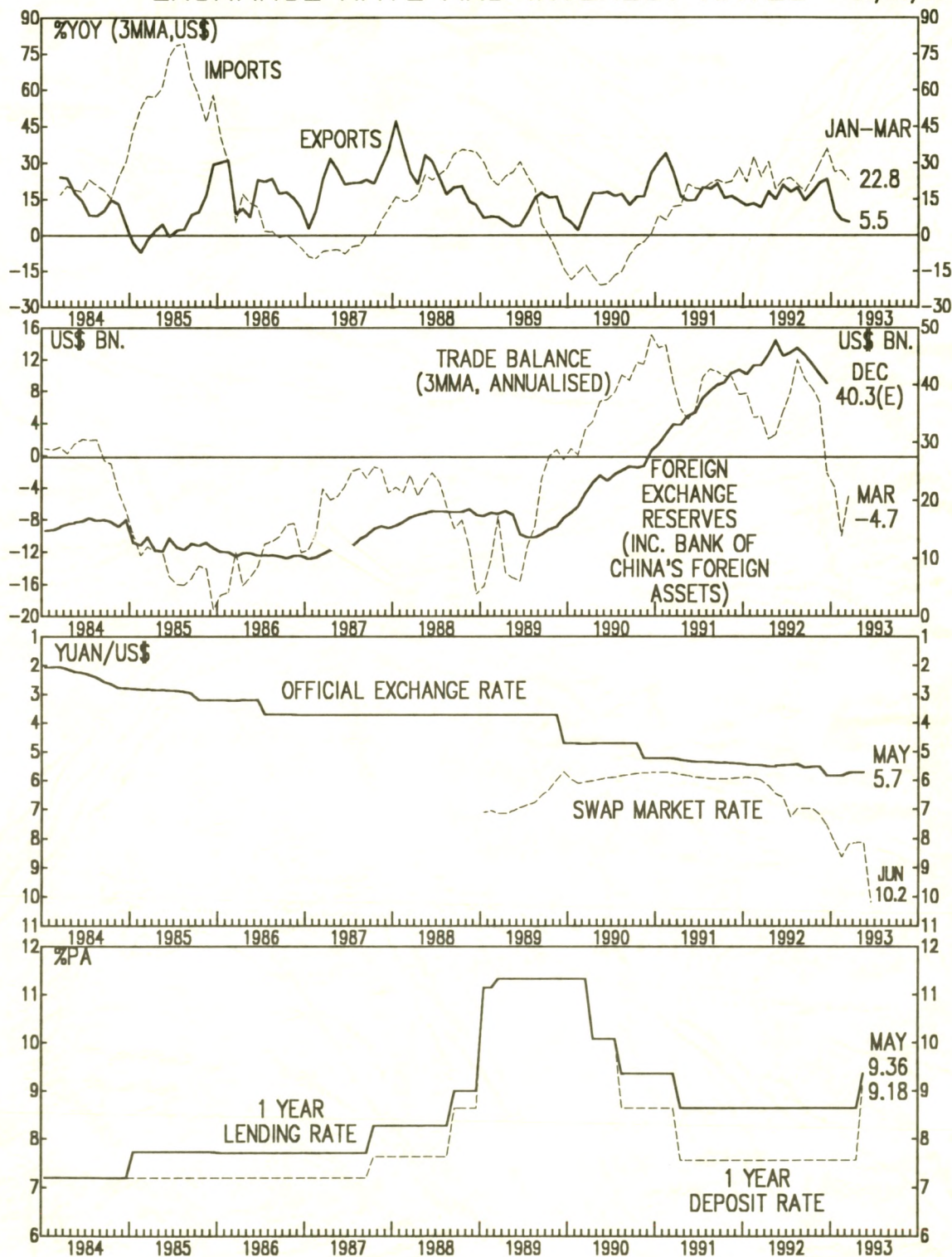


In recent weeks, the signs of nascent economic tightening have emerged in China. The evidence of overheating has been clear for some time but it had not been politic to talk about slowing the economy when Deng Xiaoping had thrown his weight behind fast growth policies. Nevertheless, recent events have obviously convinced the Patriarch that a certain degree of tightening is now necessary and his proteges have started to talk tough and to apply the brakes. Figures show that real GDP expanded 14.1% yoy during 1993 Q1. The value of industrial production rose 22.4% over the same period and retail sales grew 16.2%, while fixed investment by state-owned enterprises surged a remarkable 70.7%. The downside is that inflation also rose sharply hitting 8.6% nationwide, and 15.7% in the major cities. Some of these rises can be attributed to the freeing of prices but more is due to 30% money supply growth for the last three years, and a failure of China's infrastructure to keep up with production. Energy production grew by only 4% yoy during the quarter while freight volumes declined. As a result, prices for raw materials such as steel (up 137.5% since the end of the year) have skyrocketed. For the moment wages in the cities are rising faster than inflation at 27% yoy and the supply of consumer goods in the shops is ample. Urban unrest does not therefore appear imminent but the authorities, mindful of the demonstrations of 1989, are moving earlier this time to try to cap price rises. The public remains skeptical though, hence a surge in demand for gold (retail sales of gold jumped 70% during the quarter) and other hedge vehicles, and for imported consumer goods. Import growth remains very strong and has led to a sharp deterioration in the balance of trade and a sudden fall in foreign exchange reserves. Moreover, following its float at the beginning of June, the swap market rate is now in line with the black market rate, having tumbled to an 80% discount to the official exchange rate.

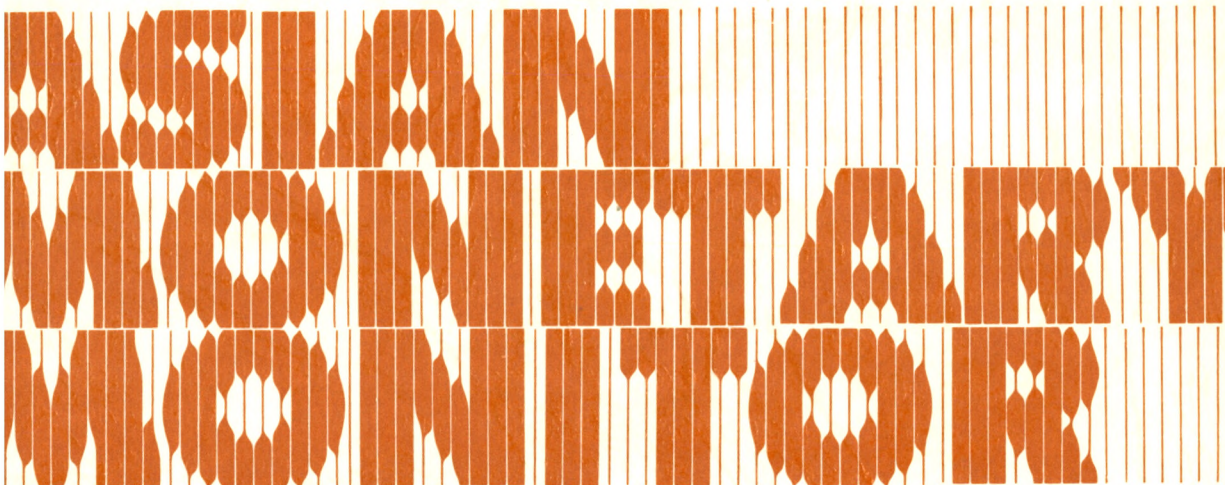
Measures taken to date by the authorities to slow the economy include bans on new issues of stocks and bonds, blocks on credit for "speculative" purposes (mainly real estate), forced government bond sales to provincial governments and state-owned enterprises, and most recently, a tentative rise in interest rates. The aim appears to be to engineer a soft landing but given the underdeveloped Chinese financial system, such a task will be elusive. Over the next few months we therefore can expect to see further interest rate hikes, more draconian credit controls, and now the MFN debate is out of the way, import controls, surreptitious or otherwise. Although the authorities have recently stopped intervening in the swap market (probably to stem foreign exchange reserve rundowns), devaluation of the official rate is less likely this time round because of: (1) China's ongoing GATT application, (2) heavy servicing costs due over the next couple of years on an external debt of US\$69 billion, and (3) a high absolute level of foreign exchange reserves (despite recent falls). Indeed the swap rate could start to firm as the squeeze intensifies and Chinese entities begin to liquidate and repatriate overseas assets.

CHINA: TRADE, RESERVES, EXCHANGE RATE AND INTEREST RATES

04/06/93







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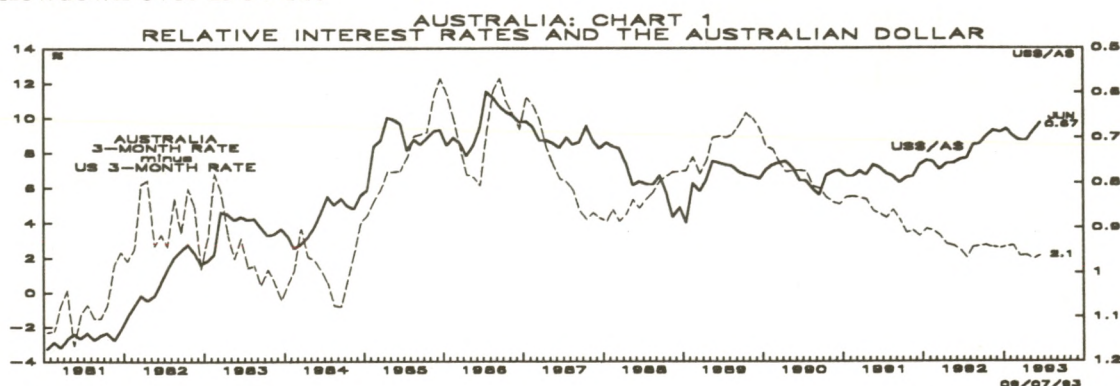
AUSTRALIA DOMESTICALLY CONSTRAINED BY GLOBAL SLUMP

Introduction

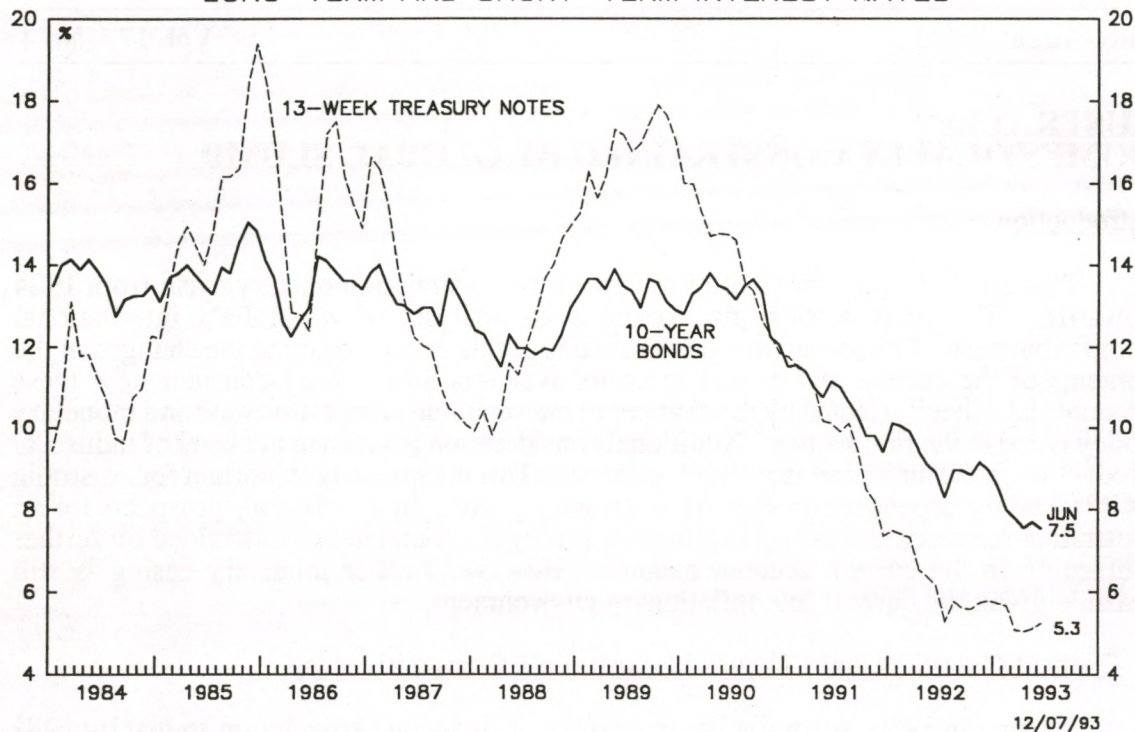
This article begins with a brief review of the Australian monetary cycle from 1984 onwards. This first section also contains an analysis of Australia's international competitiveness. The second and third sections of this article examine the changes in the contents of the current and capital accounts over this time. They consider how these accounts have been affected by the changes in international competitiveness and monetary policy noted in the first section. Additional consideration is given to the level of industrial production in the major industrialised countries. This is especially important for Australia as it is heavily dependent on exports of primary goods. In conclusion, prospects for an Australian recovery and easing in monetary policy are found to be constrained by further worsening in the current account balance. However further monetary easing is still feasible given the current low inflationary environment.

A Cyclical Overview and Changes in Australia's Competitiveness

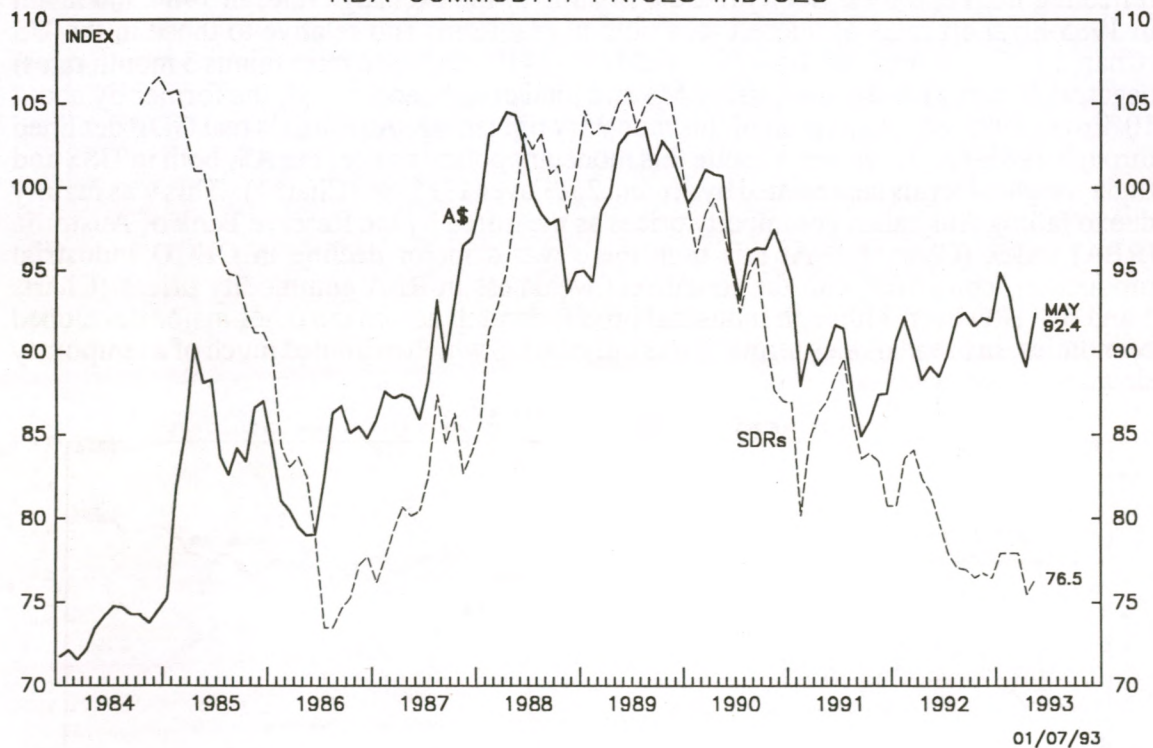
Starting in 1980, Australia began a policy of financial deregulation so that by 1983 its interest rate ceilings, credit allocation directives and foreign exchange controls had all been abolished. This enabled both the interest and exchange rates to move freely, reflecting market forces. Soon after the floating of the exchange rate, in 1984 and again in 1985-86 short rates of interest rose both in real terms and relative to those in the US (Chart 1). This turned the Australian yield curve (10 year bond rates minus 3 month rates) negative (Chart 2) and consequently M3 and total credit decelerated, the former by about 10% over 1985-86. As a result of this monetary tightening, Australia's real GDP declined through 1985-86. However, despite this monetary policy stance, the A\$, both in US\$ and trade weighted terms depreciated by around 25% over 1985-86 (Chart 4). This was mainly due to falling Australian commodity prices as measured by the Reserve Bank of Australia (RBA) index (Chart 3). At this time there was a major decline in OECD industrial production, consistent with the concurrent weakness in RBA commodity prices (Charts 5 and 6). However, although industrial production fell across the other major developed economies, in broad money terms, it was only the US which exhibited much of a temporary slowdown over 1984-86.



AUSTRALIA: CHART 2
LONG-TERM AND SHORT-TERM INTEREST RATES



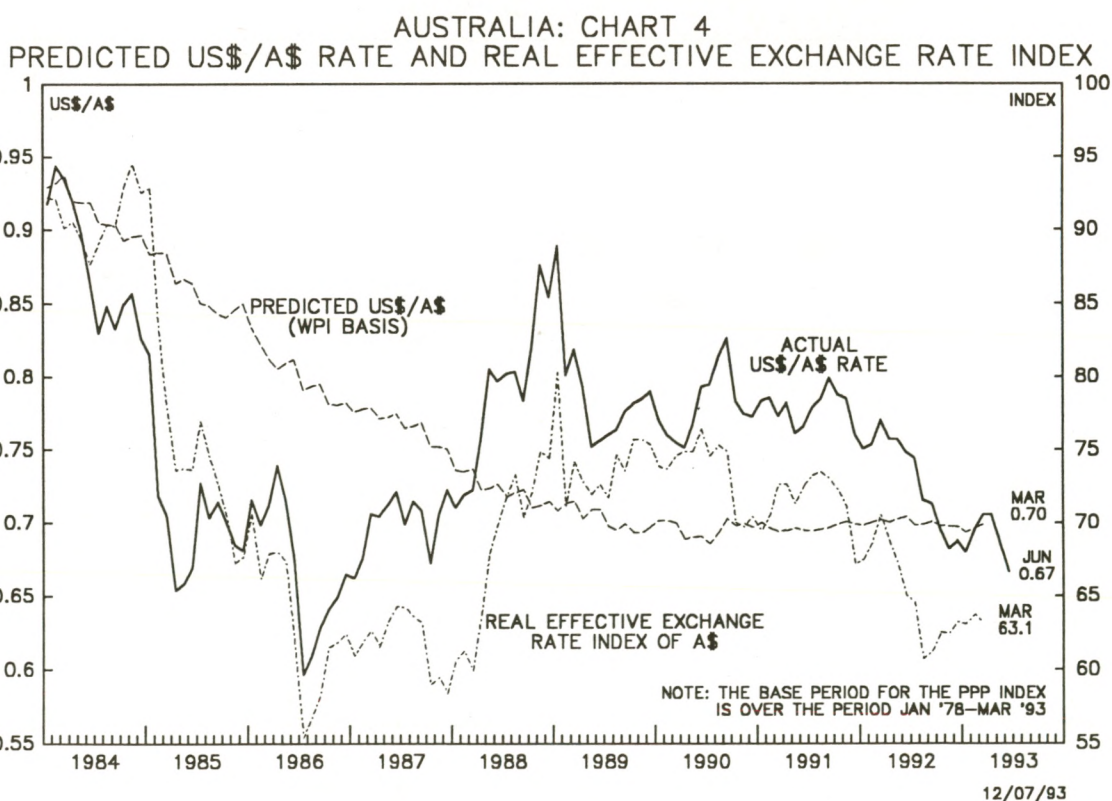
AUSTRALIA: CHART 3
RBA COMMODITY PRICES INDICES



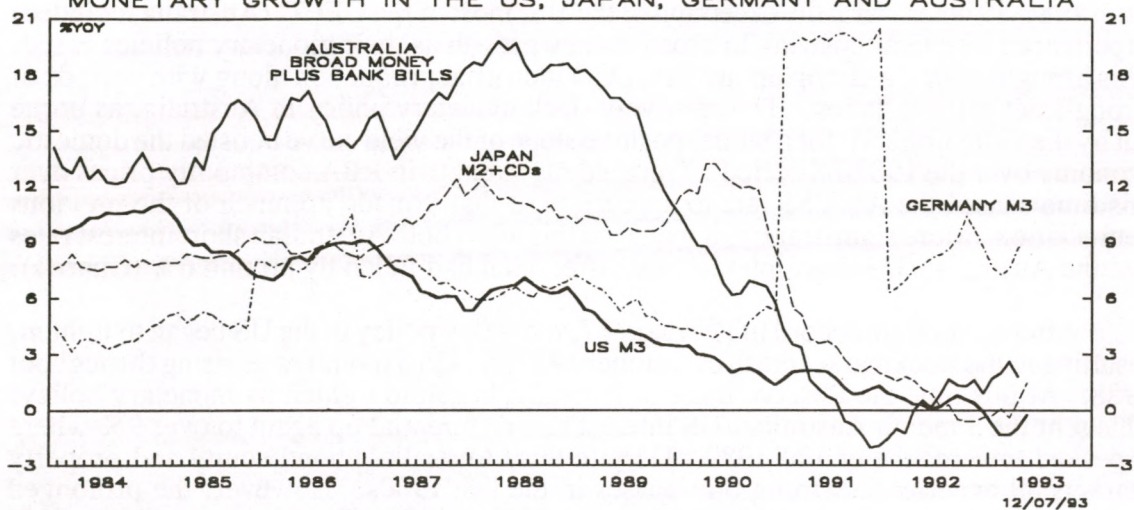
The 1984-86 period of decline in Australian real GDP growth (Chart 7) was reversed from 1987-89 when, with the exception of the US, most of the OECD (Australia included) experienced a general upswing in broad money growth as their monetary policies eased. This brought with it a strong upturn in OECD industrial production along with periods of strong asset price inflation. The relatively slack monetary policy in Australia, as borne out by the flattening and, for a while, positive slope of the yield curve boosted the domestic economy over the 1987-88 period. Tremendous strength in RBA commodity prices over this time caused the A\$/US\$ rate to appreciate so that it made up much of the previous depreciation. More significantly, it managed this when both Australian short interest rates and the Australian/US short interest rate differential had fallen by around 6% (Chart 1).

After the Louvre accord in February 87, monetary policy in the US began to tighten, resulting in the stockmarket crash of October 1987 and US 3 month rates rising throughout 1988. At this time the Reserve Bank of Australia began to tighten its monetary policy. This sent the 3 month Australian/US interest rate differential up again to over 9% where it peaked towards the end of 1989. Despite this, Australia's bond equity and property markets all experienced strong bull phases in the late 1980s. However, the prolonged negative yield curve which was held from mid-1988 to 1990 (Chart 2) eventually brought down the rapid extension of credit and made it more difficult for borrowers to pay back debt. As a result from 1990-92 banks found themselves having to restructure their balance sheets. This led to a recession in the economy which in turn has brought down CPI inflation in Australia from over 8% in 1990 to 1-2% during 1990-1993. Both long and shorter term rates have followed this decline.

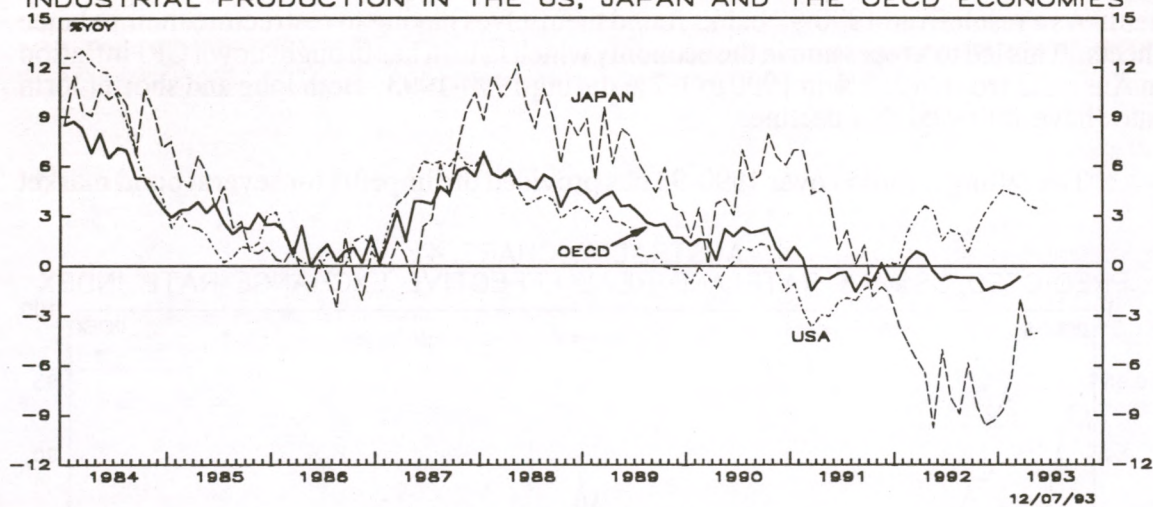
The falling inflation over 1990-93 has provided the impetus for several bond market



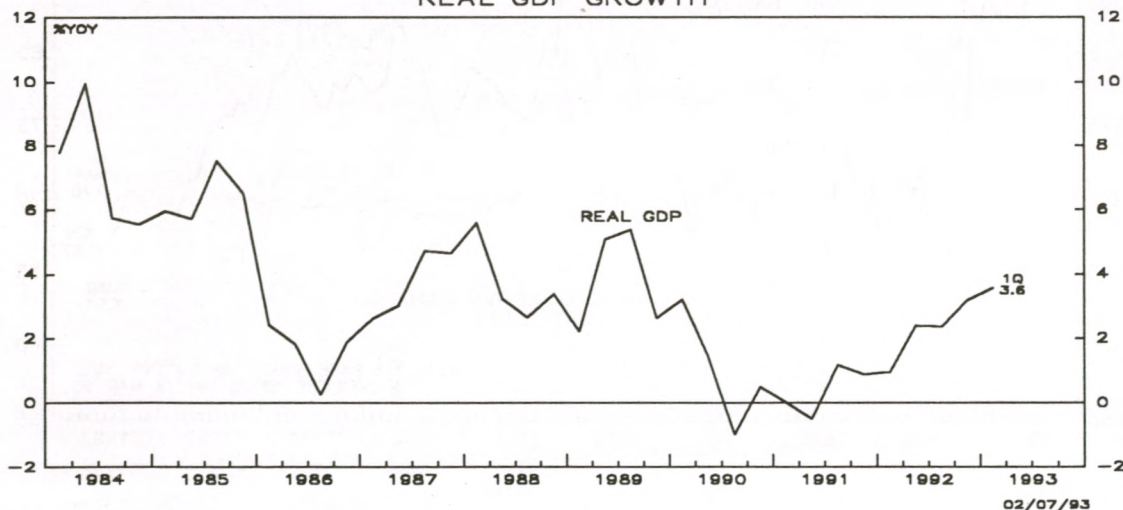
AUSTRALIA: CHART 5
MONETARY GROWTH IN THE US, JAPAN, GERMANY AND AUSTRALIA



AUSTRALIA: CHART 6
INDUSTRIAL PRODUCTION IN THE US, JAPAN AND THE OECD ECONOMIES



AUSTRALIA: CHART 7
REAL GDP GROWTH

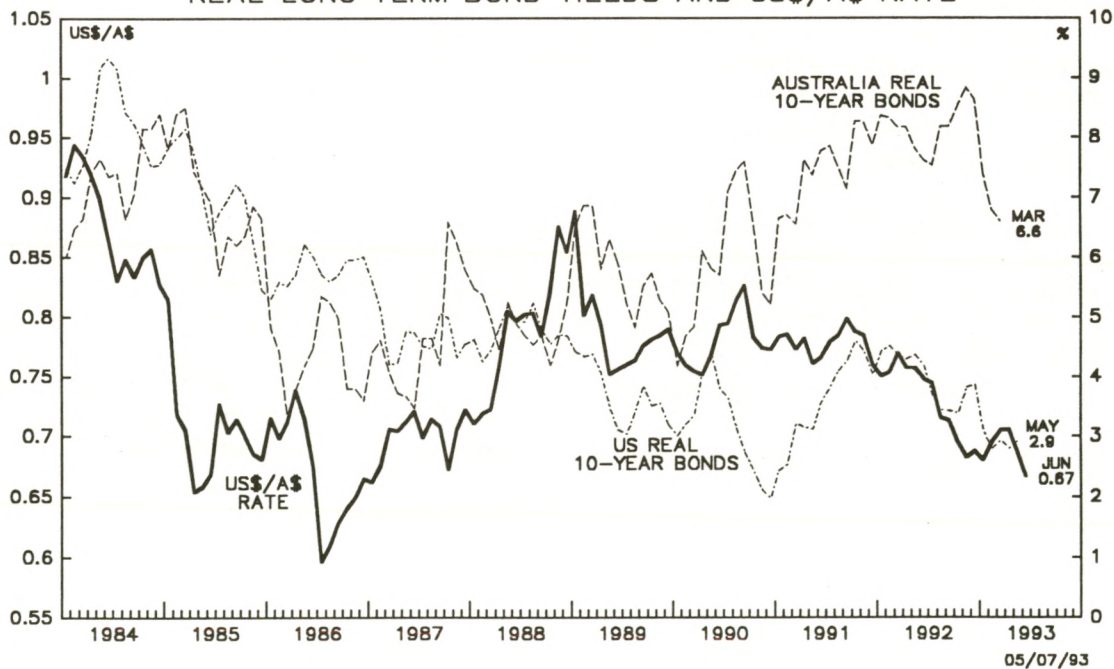


rallies. However, although nominal bond yields have been falling for the past 3-4 years, real bond yields actually rose during this period (Chart 8). It was only at the beginning of 1993 that they fell back to 1990 levels.

From 1989-90 to the present day the A\$ has depreciated against a basket of currencies for two reasons (Chart 4). Firstly, there has been a fall in the RBA index which has weakened the currency. The US, followed later by other OECD countries, entered recession in 1989 and this led to a substantial weakening in world metal and mineral prices. The RBA index, which contains those metals and agricultural products pertinent to Australia then started its 3-4 year decline. As has been previously observed a weak RBA index is sufficient to pull down the external value of the A\$, or at least keep it weak. Secondly, the Australian/US 3 month interest rate differential has shown a continuous decline over 1989-93 as Australian short term interest rates have been lowered faster than those in the US (Chart 1). This, to some extent, will have reduced the relative attraction of holding Australian dollar deposits.

As previously noted inflation came down by 7-8% over 1990-93. This on its own might be expected to contribute to a strengthening in the external value of the A\$. However, the effective (trade weighted) exchange rate of the A\$ in real terms has actually declined by about 16% over 1990-93 (Chart 4). As this has occurred during a time when inflation has fallen by 7-8%, it marks a real increase in competitiveness which should be sustained if monetary policy is used to keep inflation steady and low. This contrasts with the 30% depreciation of the A\$/US\$ in 1985-86 which was accompanied by a rise in inflation by around 4%. If the bilateral A\$/US\$ rate is compared with the ratio of wholesale prices in Australia to the US, it seems to have been persistently overvalued over

AUSTRALIA: CHART 8
REAL LONG TERM BOND YIELDS AND US\$/A\$ RATE



1988-92. Only since the start of 1993 has the A\$/US\$ become more fairly valued on this purchasing power parity (PPP) criterion. In the following two sections the current and capital accounts are discussed with reference to the monetary developments mentioned here.

The Current Account

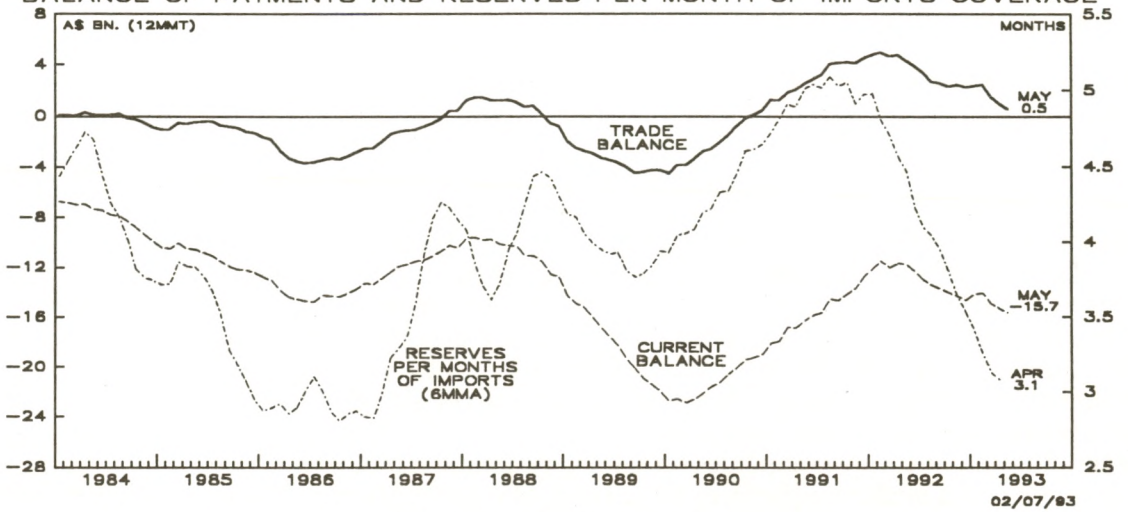
The current account has not seen a surplus for over 20 years, although the merchandise trade balance showed a surplus throughout the 1970s and has fluctuated in and out of surplus twice since 1984. There are two reasons for the observable disparity between the trade and current account balances since 1984 (Chart 9). Firstly, Australia has always run a stable deficit on its trade in services. Secondly, net investment income has exhibited an expanding deficit over this time (Chart 10). This has grown more quickly over the late 1980s, partly reflecting increased private and public sector long term debt repayments. Aside from these two factors, the cycles of the current and trade balances closely match.

Over the 1984-86 period, when the trade account swung into deficit, the growth rates of exports and imports decelerated (Chart 11). As this was a period of falling OECD industrial production, weak RBA commodity prices and a depreciating A\$, commodity export earnings fell. This contributed to a deterioration in the trade balance. However, to some extent, the deceleration in import growth, which was partly caused by a weakening domestic economy and partly by a weaker A\$, prevented further deterioration in the trade balance.

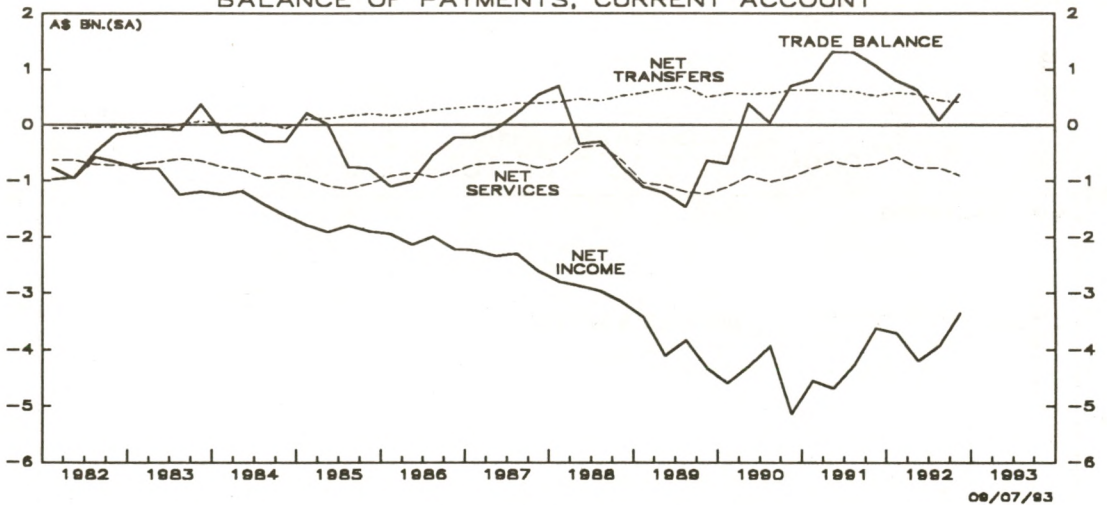
Over 1987-90 Australia's trade balance went through a complete cycle by moving into surplus, then into deficit and back again. In the first couple of years the improvement in the trade balance was mainly due to a revival in world industrial production and the accompanying surge in the RBA index (Charts 3 and 6). This combined with the easy monetary policy led to an expansion in domestic demand, which in turn contributed to the subsequent downswing in the trade balance when imports sustained rapid growth of at least 15% over 1989-90.

By 1990 the domestic monetary belt tightening had begun to bite. Domestic demand contracted and stayed limp for a longer period of time than was the case in 1985-86. This brought about a sharp and sustained decline in the value of import growth which helped move the trade balance into surplus. In addition, the decline in inflation along with the real exchange rate depreciation during this time gave Australian manufactures a competitive edge which had been lacking in previous years. However acting against this was the decline in the RBA index from 1990-93, which together with the A\$ depreciation would have reduced earnings from commodity exports. Despite this adverse commodity effect on exports there was a general improvement in the trade balance until comparatively recently in 1992-93.

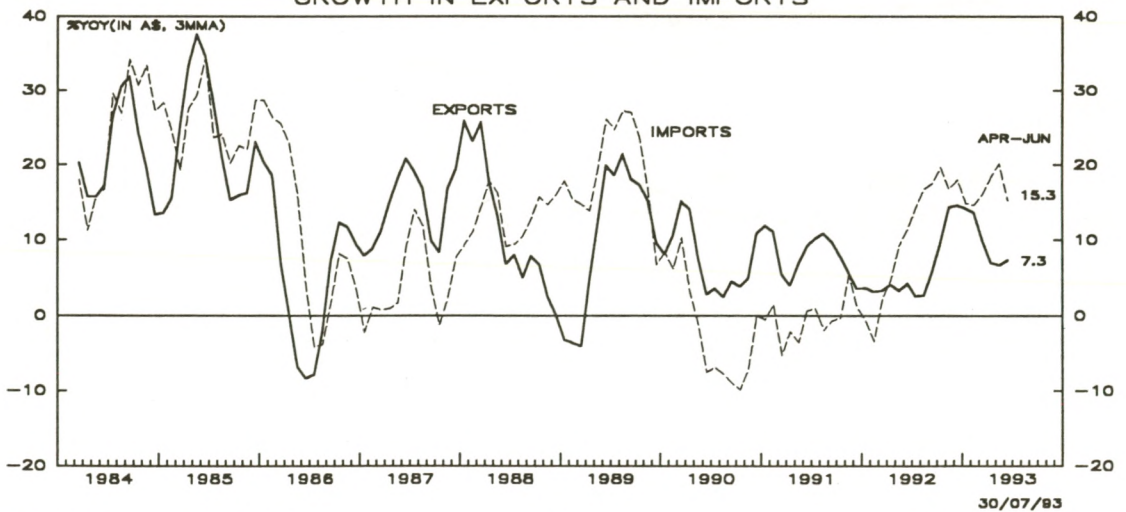
AUSTRALIA: CHART 9
 BALANCE OF PAYMENTS AND RESERVES PER MONTH OF IMPORTS COVERAGE



AUSTRALIA: CHART 10
 BALANCE OF PAYMENTS, CURRENT ACCOUNT



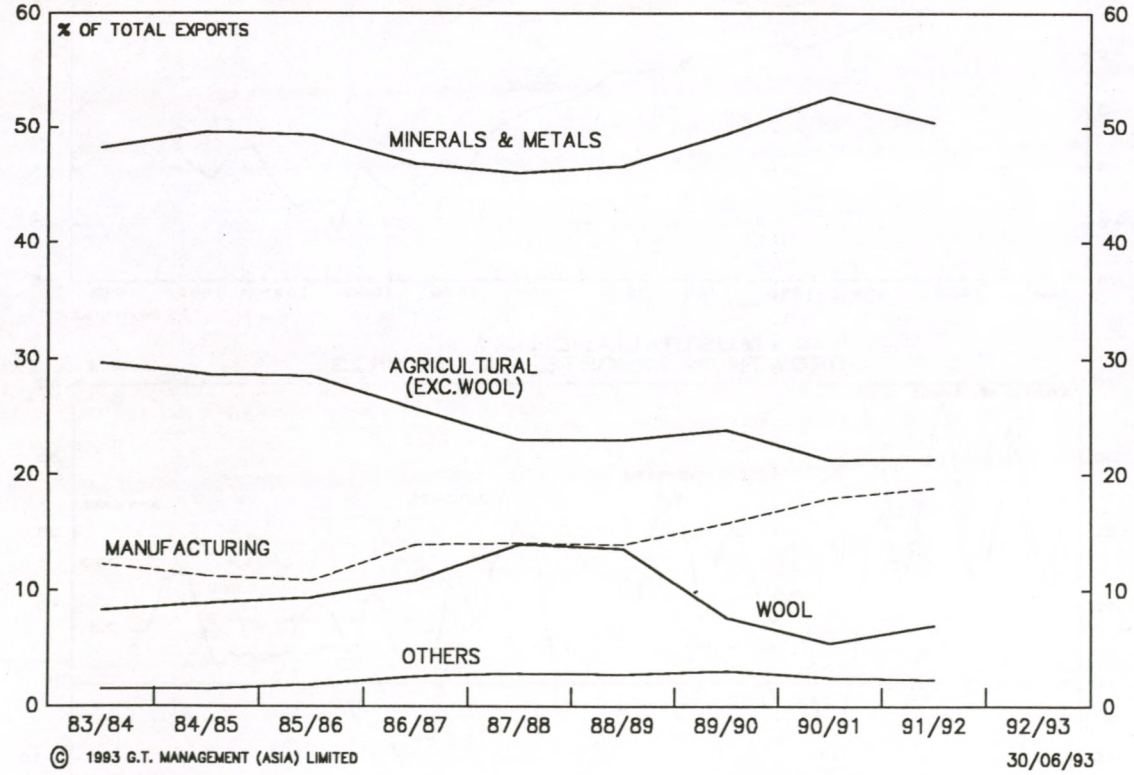
AUSTRALIA: CHART 11
 GROWTH IN EXPORTS AND IMPORTS



Unfortunately, despite the recent rise in Australian competitiveness, most types of Australian exports have been adversely hit by the economic slowdown in many of its major markets over 1992. This together with a rise in the domestic demand for imports has caused the recent and ongoing deterioration in the trade balance.

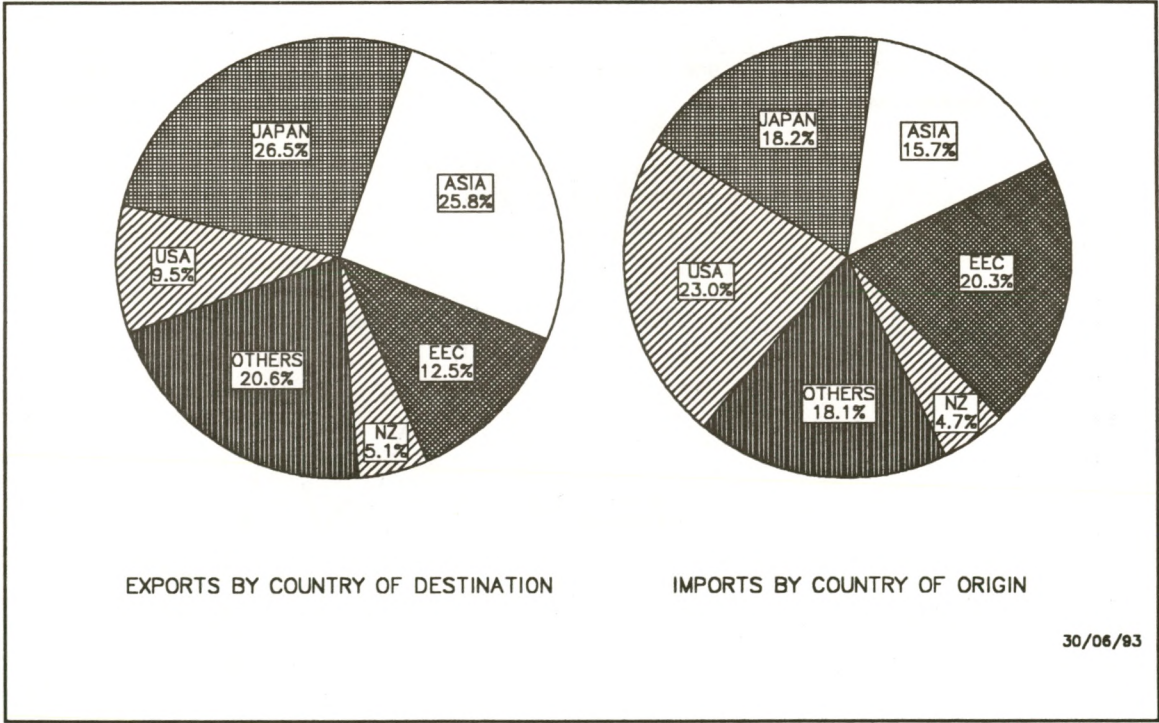
Traditionally Australia has enjoyed an improvement in exports and sometimes in trade when RBA commodity prices have been strong. The importance of primary products can be seen in Chart 12. Minerals and metals make up the biggest share of total exports (at around 50%) and this has not changed much over the last 9-10 years. By contrast both wool and non-wool agricultural exports (mostly meat and cereals) as a share of the total have declined, although they still make up a sizeable proportion (around 27%). However the star of the show has clearly been manufacturing exports, whose share of total exports has doubled since 1985-86 to 20%. One factor that may have contributed to this change is the selective targetting of government subsidies to certain manufacturing industries over this period of time. Among the beneficiaries were: pharmaceutical companies and high technology engineering companies producing generators, motors and telecommunications equipment. As mentioned before, these types of exports are well placed to perform well when world economic conditions improve if the real increase in Australia's price competitiveness is held.

AUSTRALIA: CHART 12
COMMODITIES AS % OF TOTAL EXPORTS



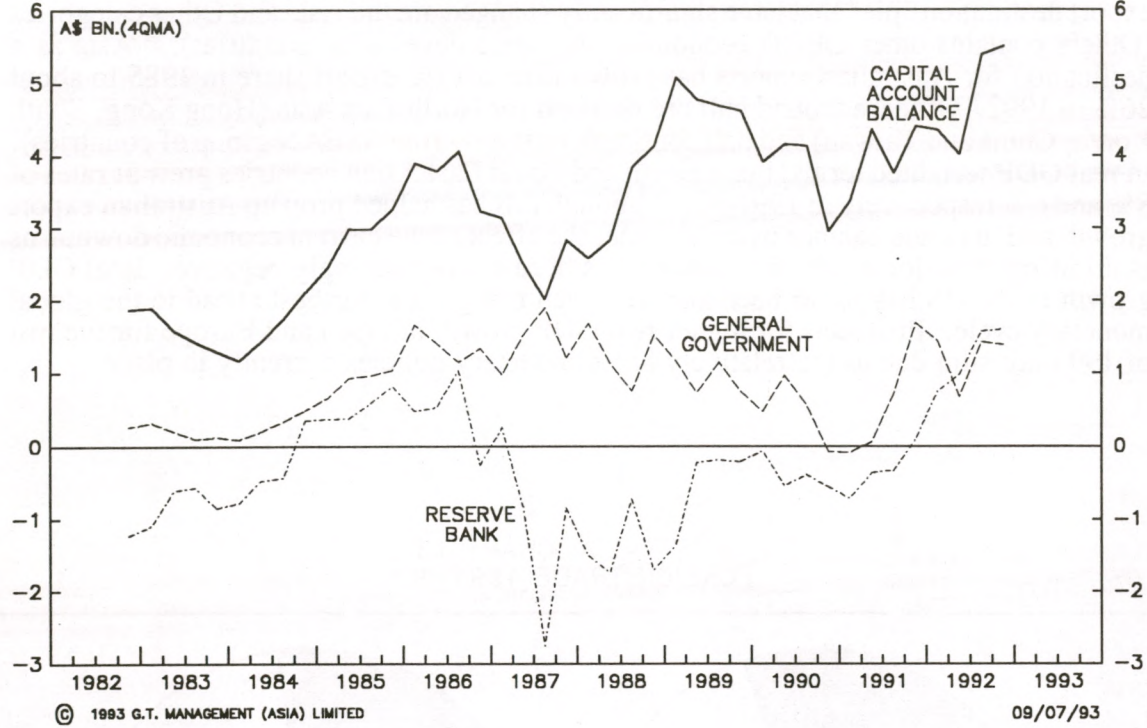
The current global economic situation does not bode well for Australian exports whether commodities or manufactures (Chart 13). Over the 1980s the only slices of the export destination "pie" that have significantly changed are the Asia and Other categories (Others contains other OECD economies and some developing countries). Asia as a destination for Australian exports has grown from a 17% export share in 1985 to about 26% in 1992. Of these around half are destined for North East Asia (Hong Kong, South Korea, China and Taiwan) and half for South East Asia (the ASEAN group of countries). In real GDP weighted terms, these North and South East Asian countries grew at rates of 8% and 6% respectively in 1991-92. Although this has helped prop up Australian export growth and the trade balance over this time, the effect of the current economic downturns in all its other major export destinations has been overwhelmingly negative. Real GDP growth in the US has so far been anaemic even though it is furthest ahead in the global monetary cycle. Prospects for higher real GDP growth in Japan and Europe for the rest of 1993 are slim due to the relatively harsh monetary policies currently in place.

AUSTRALIA: CHART 13
FOREIGN TRADE 1991-92

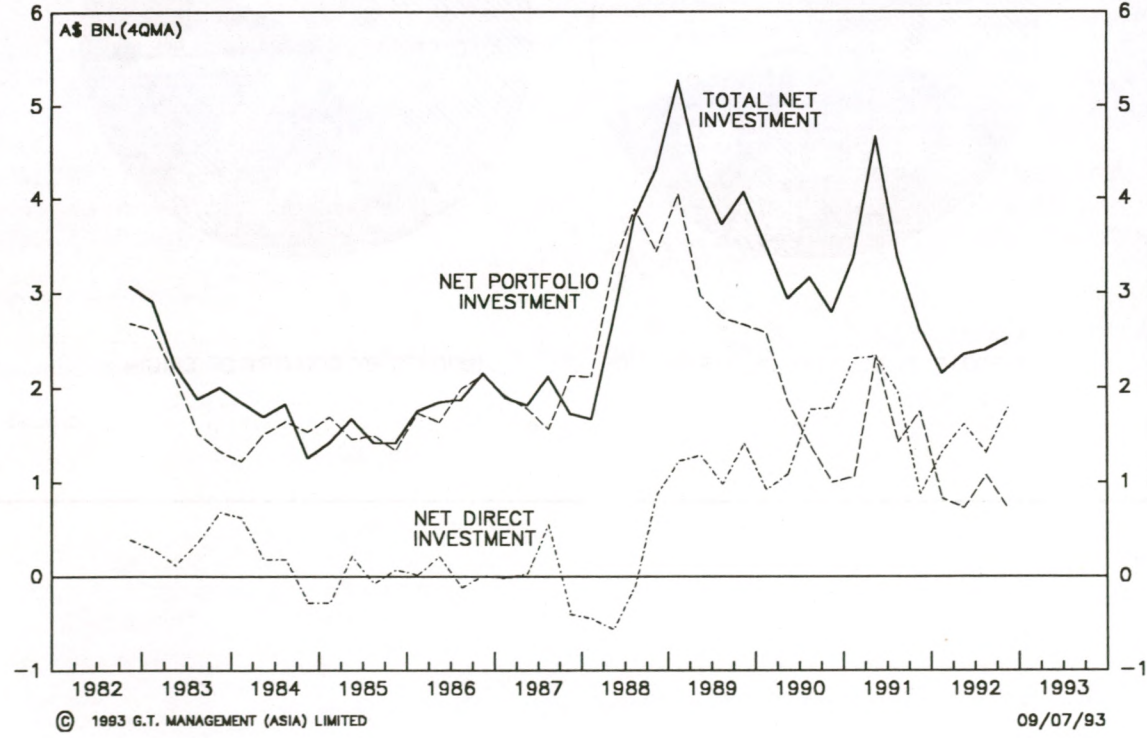


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AUSTRALIA: CHART 14
BALANCE OF PAYMENTS, CAPITAL ACCOUNT



AUSTRALIA: CHART 15
NET INVESTMENT



The Capital Account

The capital account will be examined in two parts: official and unofficial changes in capital. The unofficial capital account includes net changes in portfolio investment and net changes in foreign direct investment. Official capital comprises government and public sector net foreign borrowing along with changes in the foreign assets held at the Reserve Bank. Chart 14 shows the trend in the total capital account balance and the two official components and in Chart 15 movements in private sector capital "flows" are shown. As is to be expected the capital account cycle offsets that previously seen in the current account so that the balance of payments balances (Chart 9).

Periods when short interest rates rose relative to those in the US: in 1984-85 and again in 1988-89 did not necessarily imply an "inflow" of foreign private capital. Only in 1988 after the A\$ appreciated strongly was there a significant rise in net incoming private capital. This partly reflected the increased rate of credit creation in Australia and private borrowing going on concurrently. Both net portfolio and net direct investment into Australia rose at this time. But, unlike net portfolio investment which subsequently declined, net inward foreign direct investment displayed consistent strength throughout most of the 1988-92 period.

The official part of the capital account contains yearly net additions to RBA foreign exchange reserves and net additions of externally held government debt. The latter has risen since 1991 in line with a rise in the Commonwealth Budget deficit. If, as is widely expected, this deficit does not change much over 1993-94, there may be a similar rise in externally held government debt over the next fiscal year. Whenever there was a current account surplus or strong private capital inflow, for example in 1987 and in 1990 foreign assets temporarily rose at the Reserve Bank. This was usually accompanied by an appreciation or at least a firmer A\$ which served to counter the initial increase in value of foreign assets, in domestic currency terms. Were the Reserve Bank to operate a more managed or dirty float exchange rate policy, the changes in RBA foreign assets would be more emphasised, and, in general, closely connected with later changes in the money supply.

SUMMARY AND CONCLUSIONS: Australia's improved competitiveness will be sustained if the RBA maintains a low inflation based recovery. However, export performance is likely to stay weak until some of its major markets exhibit stronger GDP growth. The modest recovery in domestic demand and real GDP in 1992 was patchy, but nevertheless drew in imports at a faster rate. Higher GDP growth would be unsustainable throughout 1993-94 without stronger broad money growth. The current slow growth in Australian broad money aggregates is partly indicative of incomplete balance sheet restructuring and partly reflects the lack of profitable projects available at current lending rates. In the present low inflationary environment with low credit demand, there is room for the RBA to cut short rates further, gently expanding the monetary base, without provoking a significant rise in inflation. However, this combined with the prospective weakening in the current account, augurs for a weaker A\$/US\$. Recognising this, and in an effort to smooth further A\$/US\$ depreciation, the RBA may choose to delay its cuts in short rates in the immediate future. Notwithstanding future currency weakness further easing in monetary policy is necessary if the domestic economic recovery is not to remain feeble.

JAPAN

SHORT-TERM AND LONG-TERM GROWTH PROSPECTS

Introduction

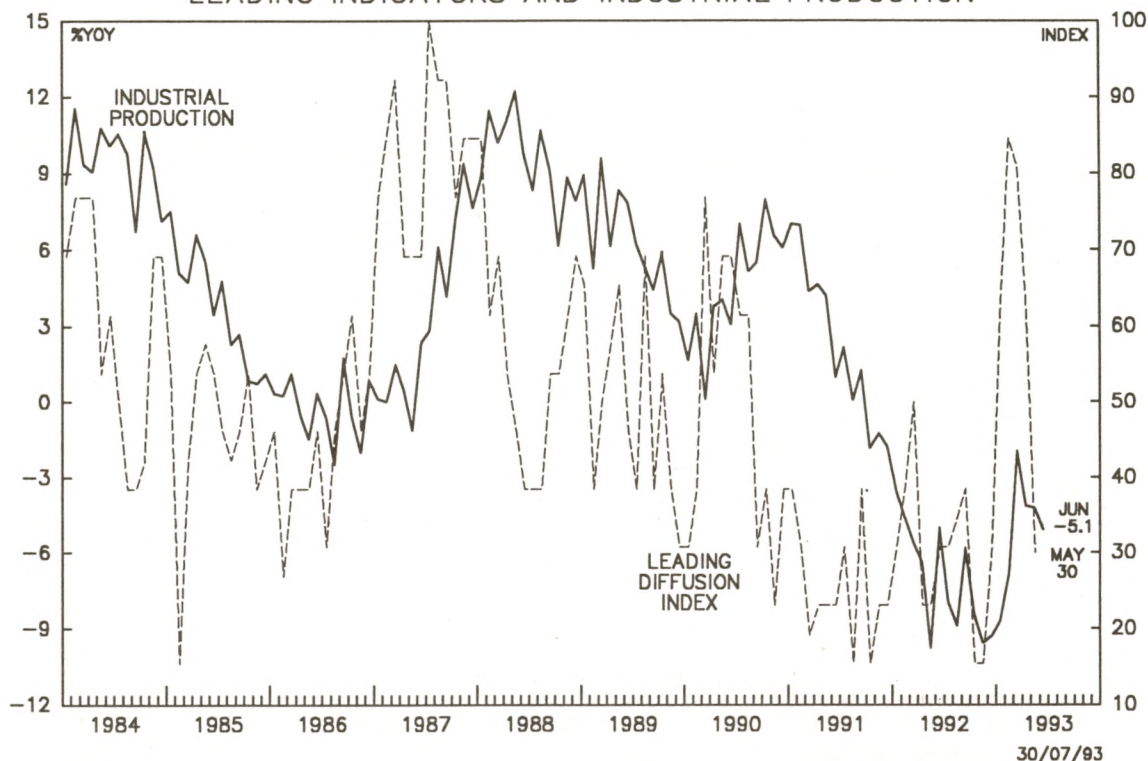
The short-term and long-term growth prospects for Japan depend on two quite different sets of influences. Short-term growth prospects depend almost entirely on business cycle factors, particularly monetary developments -- specifically the growth rate of the broad money supply (M2 + CDs). The first part of this article deals with these short-term cyclical influences. The longer term growth prospects for Japan depend on such factors as the rate of growth of productivity, the rate of growth of the labour force, and the number of hours worked. Once the short-term cyclical downturn has worked itself out and the economy is on a recovering growth path again, the longer term influences on growth will start to assert themselves. Of course, there may be a few quarters of growth which exceed the long-term trend during the early stages of recovery, but this can only be temporary while the economy is operating below its full capacity potential. The second part of this article looks at the long-term postwar record of productivity growth in Japan and argues that the trend rate of real GNP growth will decline further in the 1990's.

Section 1. Short-term Growth Prospects

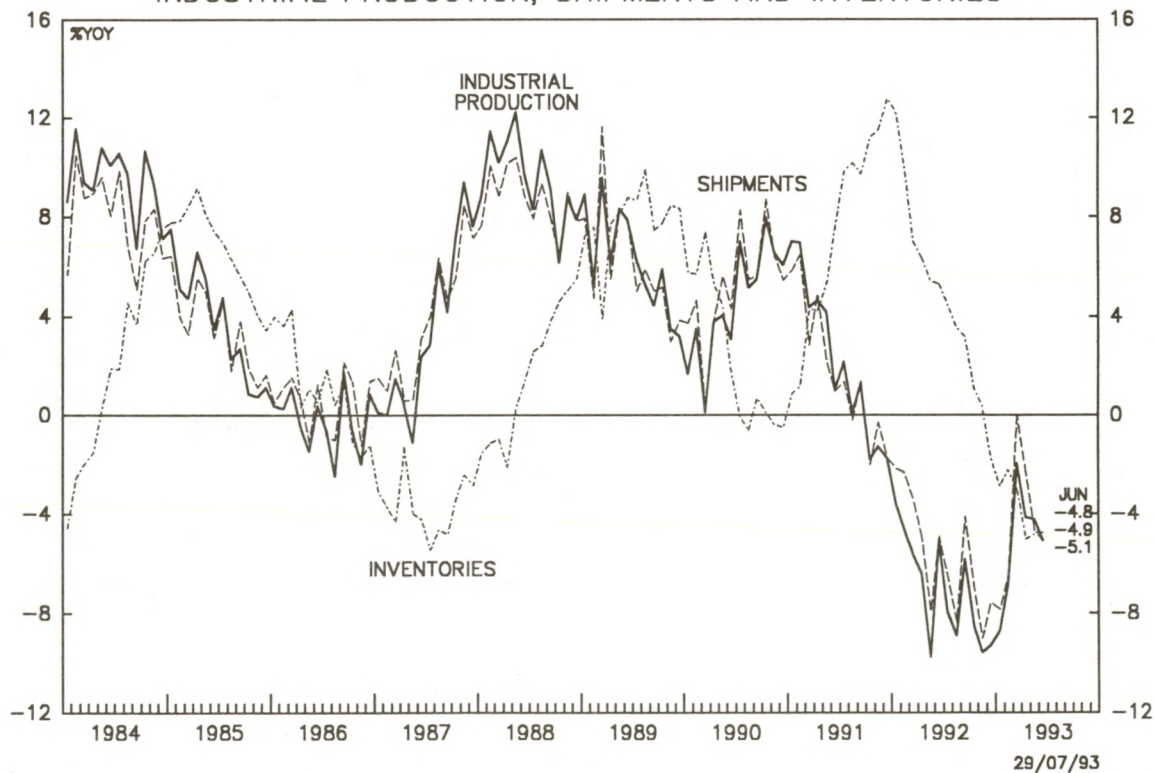
After a temporary surge in February and March, Japan's economic indicators have weakened in subsequent months (see Chart 1). The short lived upturn occurred for two reasons only. Firstly, many companies were anxious to book orders and/or sales before the end of the fiscal year on March 31st. Secondly, the government's fiscal stimulus programme, which was first announced in August 1992, was not passed by the Japanese Diet until December, and therefore the actual spending was only implemented in the period January to March, 1993. Once these temporary influences had passed, the economy reverted to the conditions determined by more general business cycle factors -- slow money growth and an appreciating currency. As a result, the economic upturn which some forecasters have pinpointed as starting in 1993 Q1 has proved to be a false dawn. Across most of the domestic sectors of the economy, real economic indicators have slumped since April and, in addition, the strengthening of the Yen has cast a long shadow over the prospects for Japanese exports.

These developments are entirely consistent with the low nominal GNP growth which we have forecast in previous issues of Asian Monetary Monitor, based on the low rates of money growth which Japan has been experiencing over the last two years. By contrast, official commentaries on Japan's economy have made much of the proposition that inventory adjustments were nearing completion, i.e. that inventories were being reduced to levels comparable with the sluggish growth of demand. In this view, once inventories had been sufficiently depleted, the economy would be in a position to spring back and generate a renewed phase of economic growth. For example, in 1987, following the inventory run-down of the two previous years (see Chart 2), industrial production was able to start rising again. However, it is also true that there was a rapid monetary acceleration in 1987 which helped to fuel the recovery. The truth is that the current economic downturn is far more than just an inventory cycle and therefore it will take far more than a mere inventory correction to set Japan on a renewed growth path.

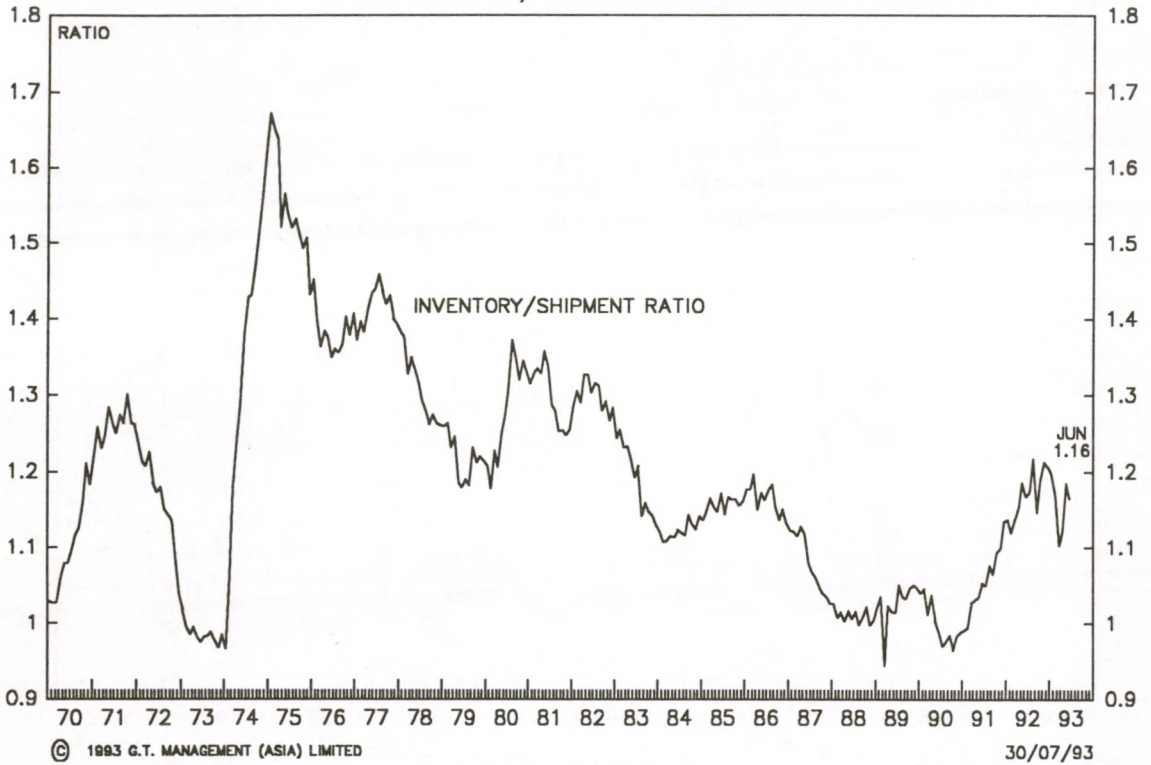
JAPAN: CHART 1
LEADING INDICATORS AND INDUSTRIAL PRODUCTION



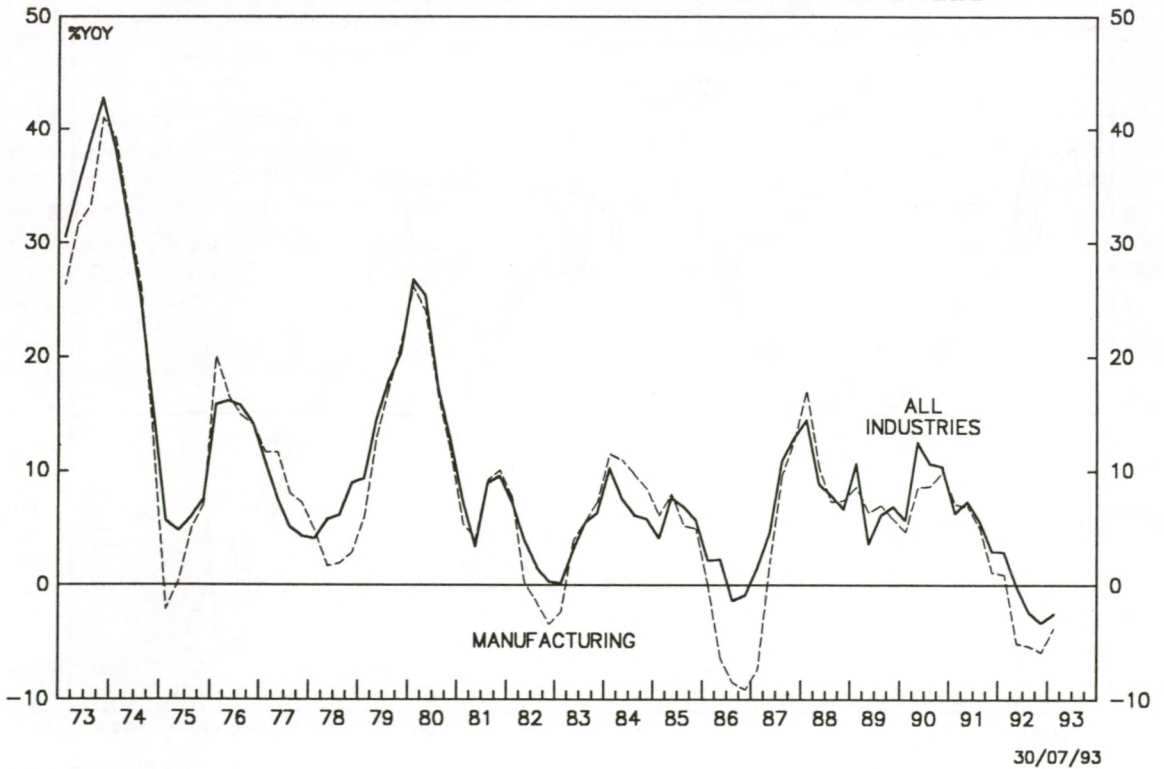
JAPAN: CHART 2
INDUSTRIAL PRODUCTION, SHIPMENTS AND INVENTORIES



JAPAN: CHART 3
INVENTORY/SHIPMENT RATIO



JAPAN: CHART 4
ALL INDUSTRIES SALES AND MANUFACTURING SALES



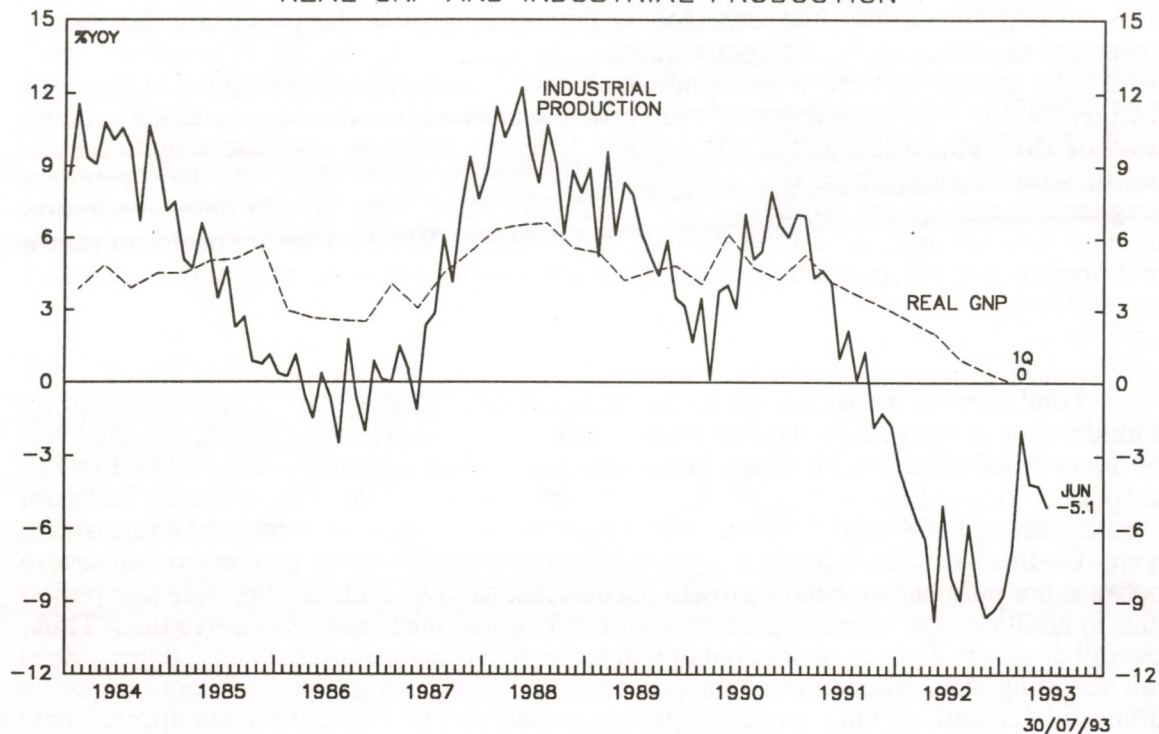
The main reason why the inventory adjustment phase seems to be taking much longer than official forecasters had expected is that sales growth keeps falling far below expectations (see Chart 4). As a consequence, the year-on-year decline in inventories may need to be greater -- or at least continue for longer -- than in previous cycles. Looked at differently, the inventory/shipment ratio probably needs to decline to around the average level of 1988-90, or just above 1.0 in Chart 3, before it can be said that inventories are in line with the sluggish pace of sales demand in the economy. This ratio has been on a long term declining trend since the 1974 recession thanks to the "just-in-time" revolution in inventory management during the past two decades. We therefore expect it to return to its long term trend, or at worst, flatten out at around 1.0, before the economy can embark on recovery.

Total sales of industrial companies in Japan (see Chart 4) can be approximated by a model (not shown) which has two main determinants: - monetary growth, and the level of the nominal effective exchange rate of the Yen. Thus for example, the slowdown in corporate sales in 1986 was largely due to the appreciation of the Yen, whereas the boom in sales between 1987 and 1990 was due to rapid monetary growth combined with a stable Yen. On this basis, the current downturn should be expected to be prolonged and severe because not only has monetary growth been at record low levels for the post war period but, in addition, the recent appreciation of the Yen will hurt Japan's export sales. Thus, overall domestic demand in nominal or real terms will remain depressed until either prices are declining at a sufficient rate to create positive real money growth sufficient to revive domestic demand, or until monetary growth accelerates to create the same approximate effect.

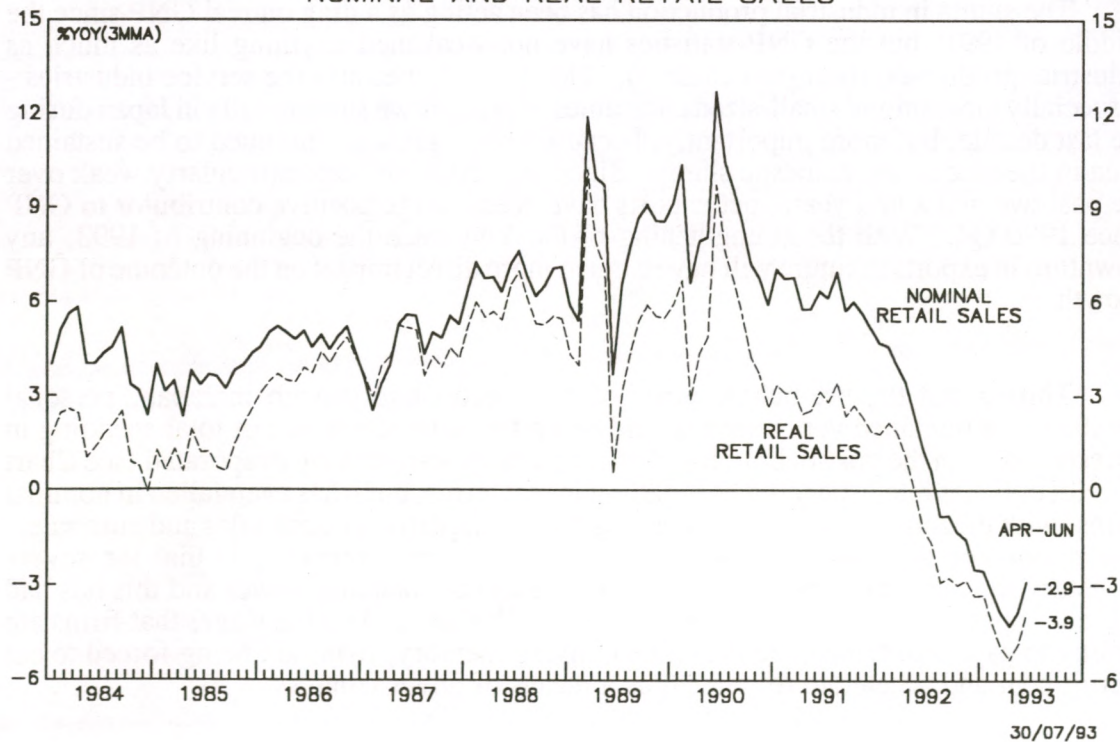
The slump in industrial production has been acting as a drag on real GNP since the middle of 1991, but the GNP statistics have not weakened anything like as much as industrial production itself (see Chart 5). This is partly because the service industries - especially medium and small-sized companies -- have grown substantially in Japan during the last decade, but more importantly, because export growth continued to be sustained even in the face of the domestic slump. Since imports have been particularly weak over the past two and a half years, net exports have been a large positive contributor to GNP since 1990 Q4. With the strengthening of the Yen since the beginning of 1993, any downturn in exports in future will have a much more direct impact on the outcome of GNP growth.

Throughout the pre-bubble years of rapid economic growth in Japan, personal consumption remained very buoyant, and much the most stable part of total spending in the economy. In the post-bubble era, that certainty appears to have evaporated (see Chart 6). Not only has retail spending been falling in real terms, but it has even fallen in nominal terms, with the most marked declines being seen in department store sales and auto sales. The reason for this unaccustomed weakness in consumer spending is that the severe monetary squeeze has abruptly curtailed the growth of spending power and this has had a direct impact on the quantity of labour firms are hiring, and on the wages that firms are willing to pay. For almost the first time in living memory, firms are being forced to cut recruitment and accelerate retirement as a means of downsizing.

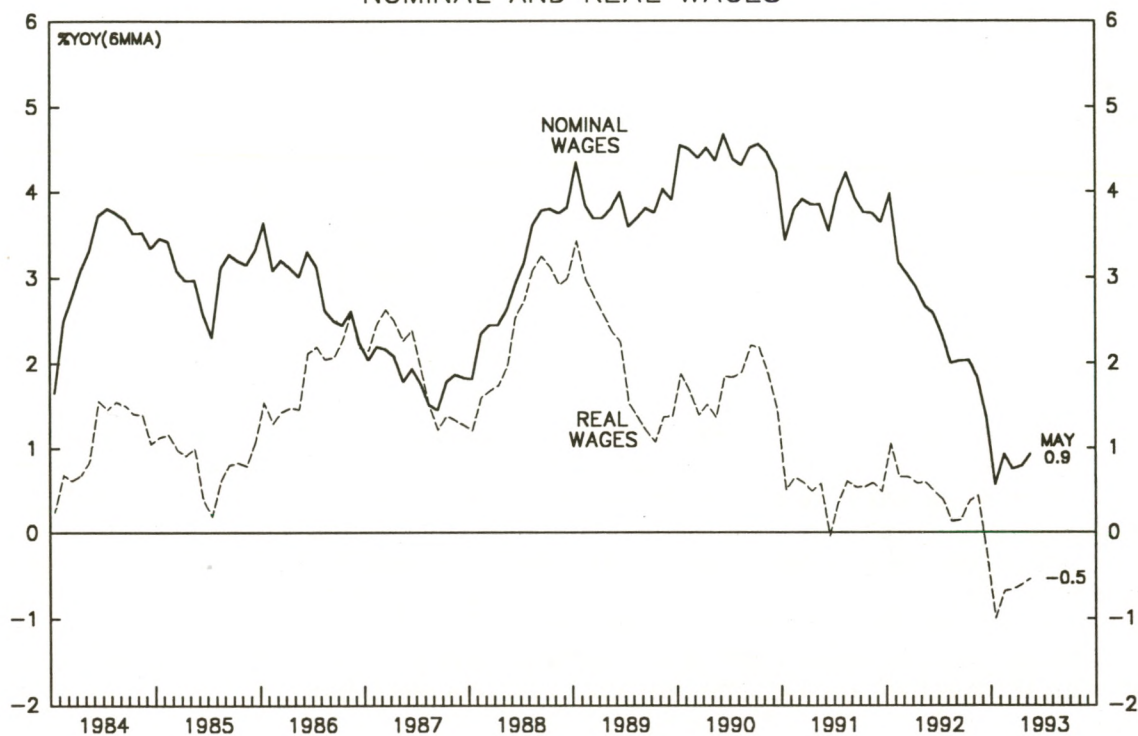
JAPAN: CHART 5
REAL GNP AND INDUSTRIAL PRODUCTION



JAPAN: CHART 6
NOMINAL AND REAL RETAIL SALES

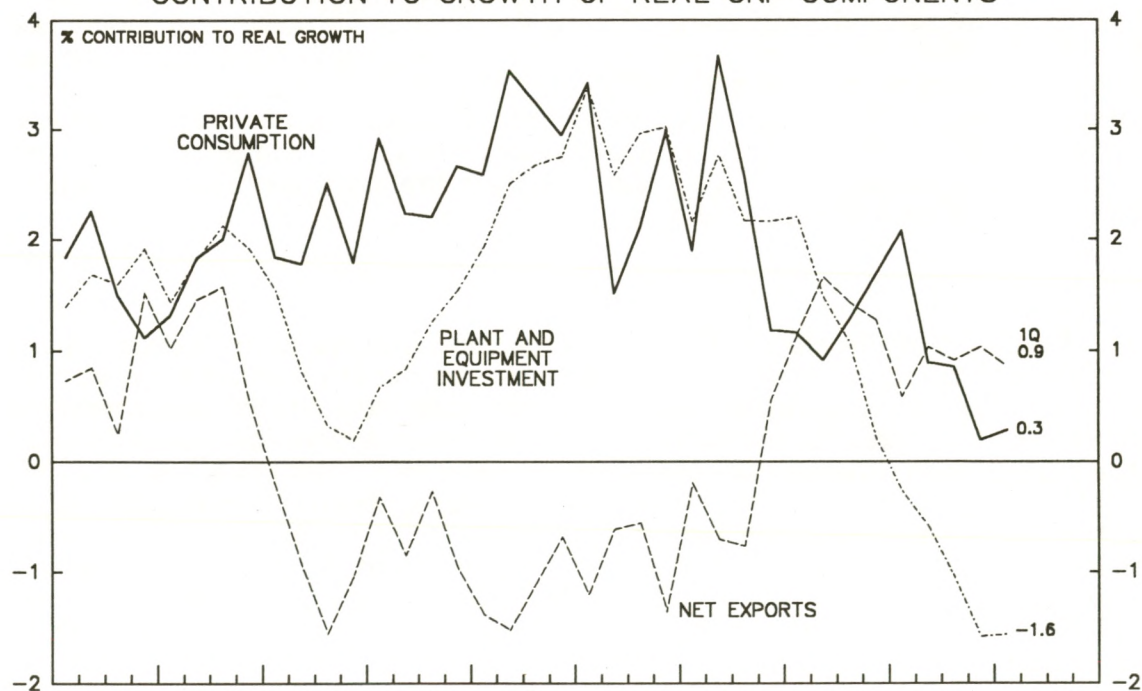


JAPAN: CHART 7
NOMINAL AND REAL WAGES



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JAPAN: CHART 8
CONTRIBUTION TO GROWTH OF REAL GNP COMPONENTS



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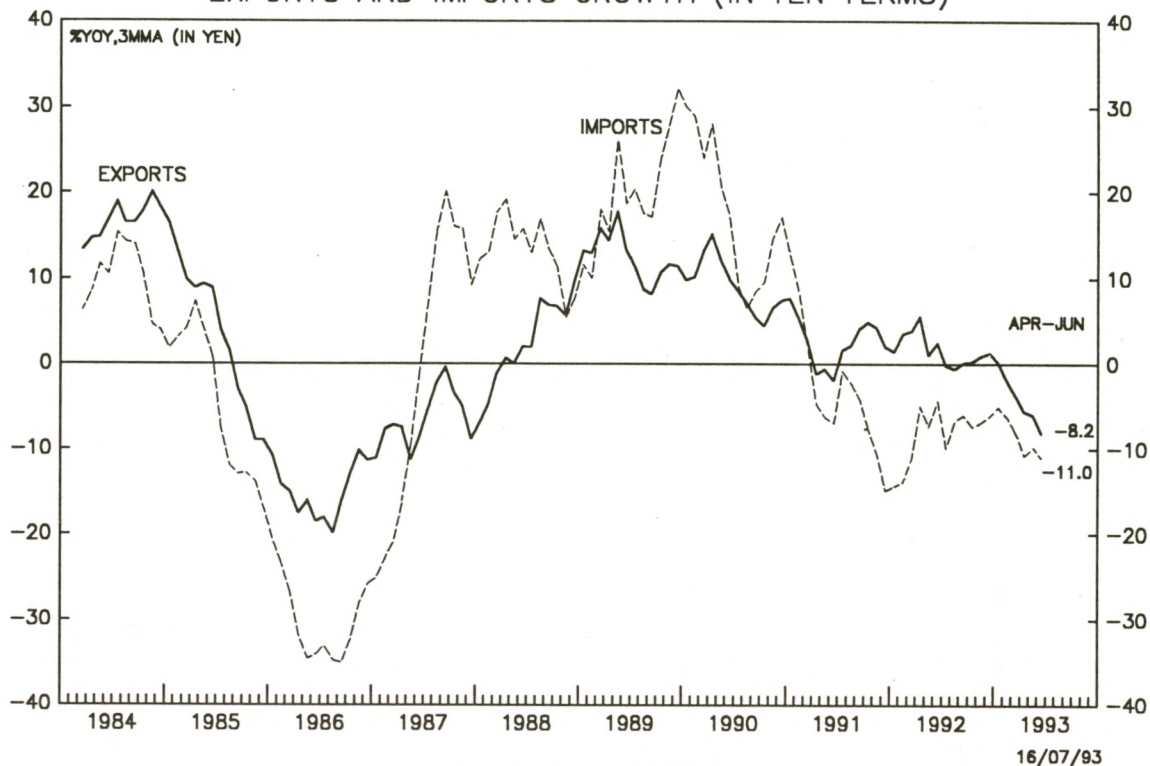
In addition, all three components of total wage earnings are under downward pressure. Traditionally, the base wage, which normally accounts for about one third to one half of total take-home pay, is raised every spring in the so-called "Shunto" or spring wage offensive. This year, the Shunto yielded base wage increases of only 3.8% in nominal terms or about 2% in real terms. Bonuses, the second largest component, are normally paid twice annually in summer and winter, and range from 3 to 24 months salary. With corporate profits declining for the third year in a row, bonuses are expected to decline yet again this summer. Finally, overtime payments have naturally been slashed as a result of the recession. Chart 7 includes all three components and shows a decline in real terms. To this must be added the fear and uncertainty about future job prospects which have accompanied Japan's most severe postwar recession.

Data on Japan's GNP for 1993 Q1 showed overall growth of 0.6% on a quarter-on-quarter basis, or only 2.4% on an annualised basis (see Chart 8). The key features were the marked weakness in private sector investment and inventories contrasting with the strength in public sector spending, which was boosted by the impact of the fiscal stimulus programme referred to earlier. Since exports weakened at approximately the same pace as imports, there was no significant change in the net export contribution to the GNP. Our expectation is that the real GNP will continue to remain weak until at least the fourth quarter of 1993 but that, provided there is a continuous easing in monetary conditions in the interim, there is then a reasonable prospect of an economic upturn in 1994.

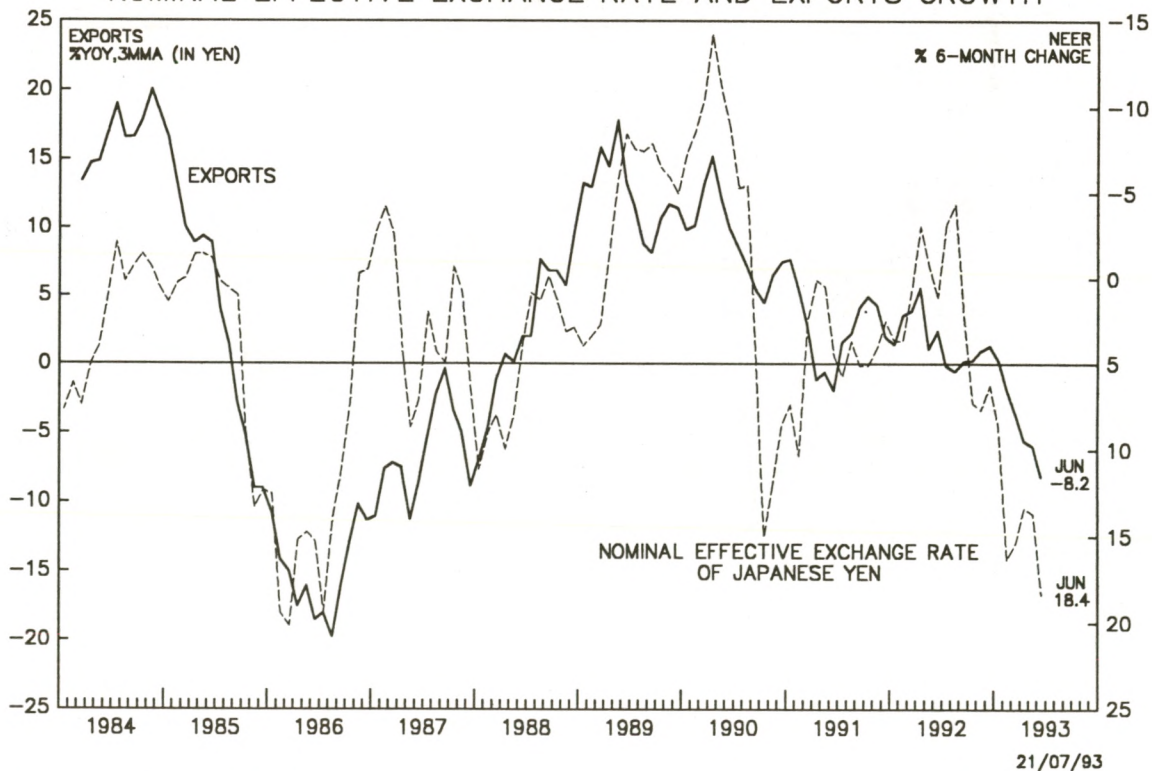
Turning to the balance of trade and the external accounts, imports in Yen terms have been falling for two and a half years reflecting the slump in the domestic economy (see Chart 9). The shorter but steeper downturn of 1985-87 was a result of the combined impact of a) a temporary period of slower growth in Japan as the Yen appreciated and b) the fall in oil prices in 1985-86. If the weakness in current domestic economic activity persists, and indeed is accentuated by the recent appreciation of the Yen, then imports will continue to fall for the remainder of 1993. As a result, the trade surplus will continue to widen until Japan's exports are affected by the Yen's appreciation.

Judging by past episodes of Yen appreciation, the responsiveness of Japanese exports to a stronger Yen is quite rapid if Yen appreciation occurs in an environment where external demand in the US and elsewhere is quite soft, and where domestic demand is weak, as in 1985-86. In the present circumstances (see Chart 10), external demand is clearly softer than in 1985-86 and domestic demand is also substantially weaker than at that time. We should therefore expect the Japanese exports to weaken quite quickly during the second half of 1993. This implies that Japan's trade surplus will peak out during the next few months and start to narrow. The only offsetting factor would be a recovery of economic activity in the OECD in 1994, but it is our view that most of Europe will remain weak until at least the second half of 1994, postponing any OECD-wide recovery until 1995 at the earliest.

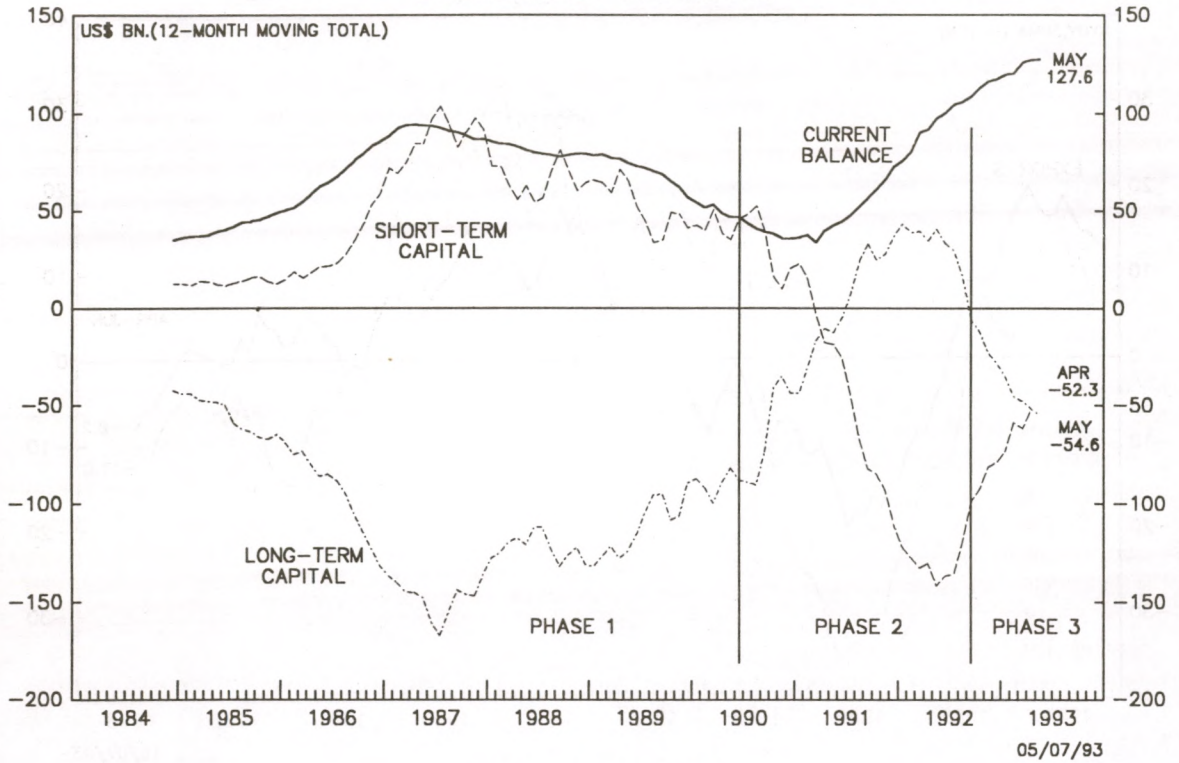
JAPAN: CHART 9
EXPORTS AND IMPORTS GROWTH (IN YEN TERMS)



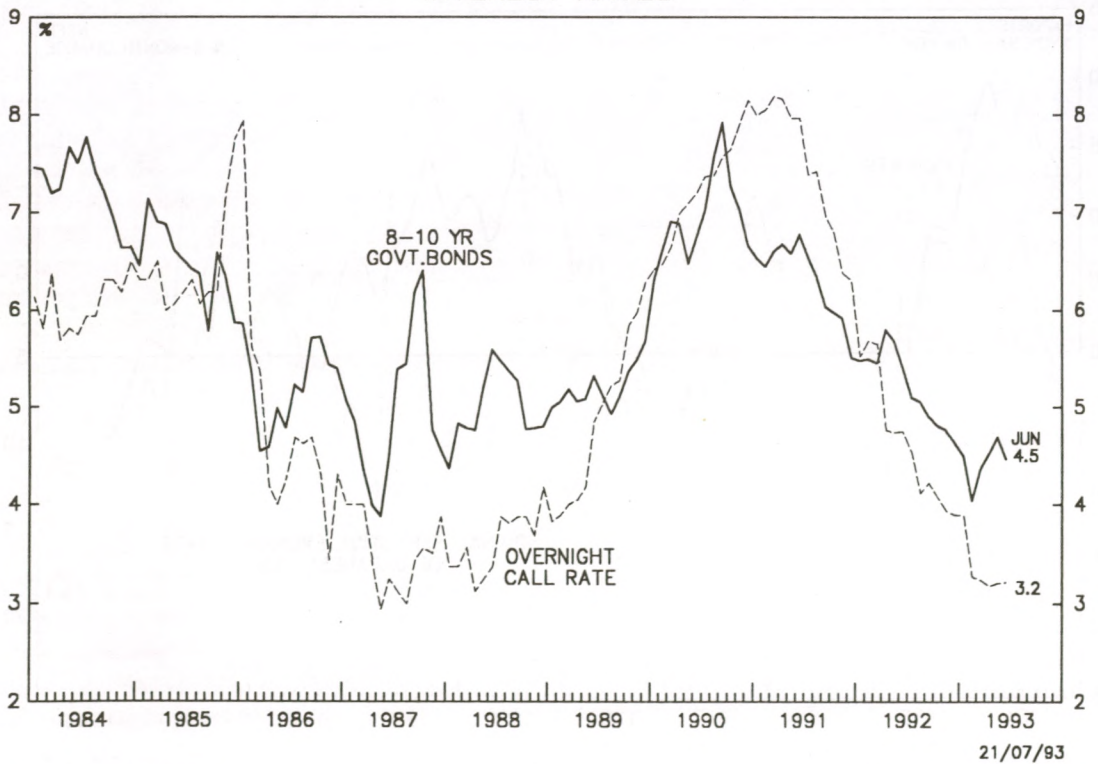
JAPAN: CHART 10
NOMINAL EFFECTIVE EXCHANGE RATE AND EXPORTS GROWTH



JAPAN: CHART 11
BALANCE OF PAYMENTS



JAPAN: CHART 12
INTEREST RATES



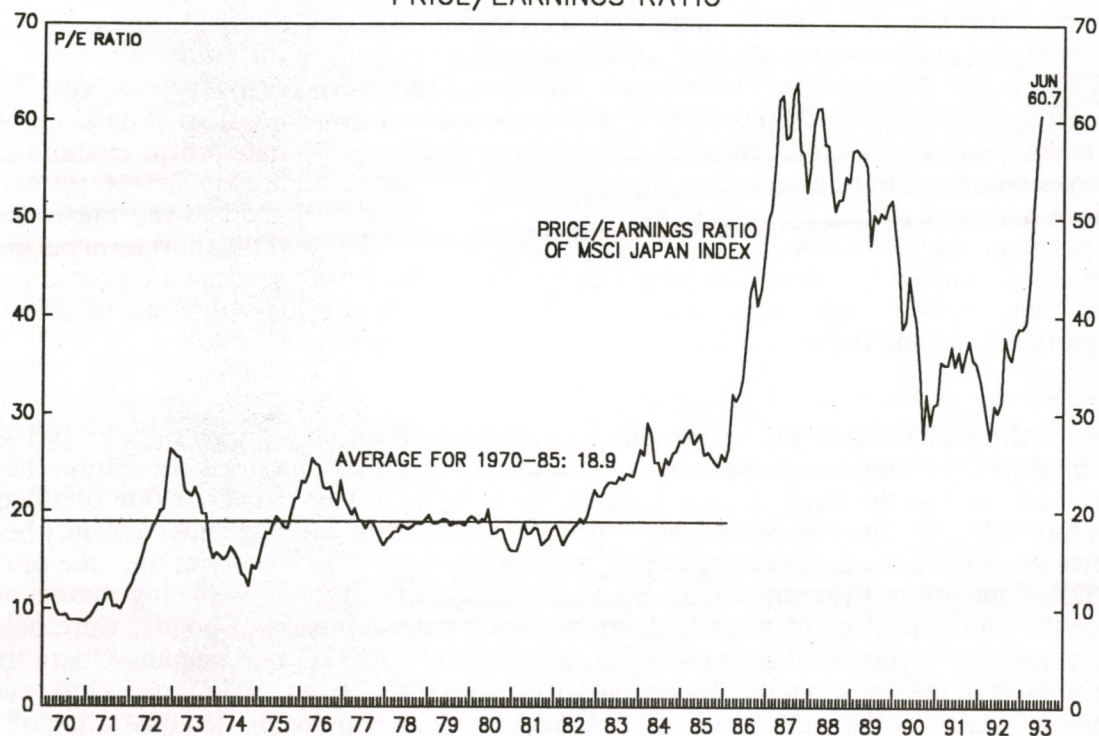
To understand Japan's balance of payments and forecast the future, a brief review of the past few years is useful. In the period up to mid-1990 (see Chart 11, Phase 1), long term capital outflows exceeded the current account surplus. The difference was financed by short-term borrowings. Essentially, Japanese firms were borrowing low-cost Yen funds and purchasing higher-yielding assets abroad. From mid-1990 (Phase 2), the monetary squeeze became effective, interest rates rose and corporate profits evaporated. Banks required their customers to liquidate long term assets and repay short term debt. Since late 1992 (Phase 3), long term capital outflows have resumed and short term debt repayments have diminished. Together, the long term outflow and the short term outflow have not matched the current account surplus, hence there has been upward pressure on the Yen. Under these conditions, the current account surplus will need to show a significant decline before the Yen can be expected to weaken.

Although the yield curve (see Chart 12) has been positively sloped since early 1992 (i.e. short term interest rates have been lower than bond yields), monetary conditions have not been easy in the sense of generating faster money growth. Also, despite two fiscal stimulus packages in August 1992 and April 1993, short term interest rates have only been lowered once in the past year by any significant margin -- specifically at the time of the ODR reduction in February 1993. Because the liquidity squeeze was being maintained and the public pension trusts, which are normally natural buyers of bonds, were being corraled into buying equities as part of the government's PKO (Price Keeping Operation) in support of the stock market, bond yields backed up sharply until early June. Thus, even this steepening of the yield curve was not, in our view, a convincing demonstration of an easing of monetary conditions. If the economy remains mired in recession as we expect, another cut in short term rates will be necessary.

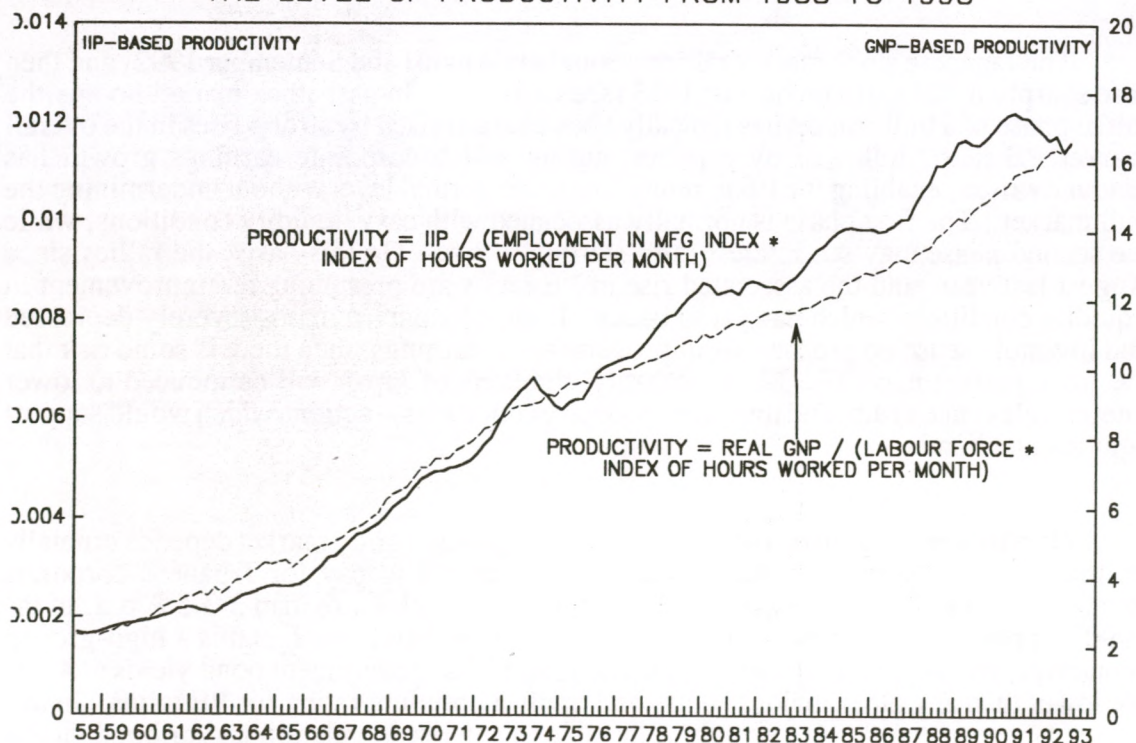
The Japanese stock market rallied strongly in August and September 1992, and then rose sharply in the early months of 1993 (see Chart 13). In past stock market booms, the initial phase of a bull market has typically been characterised by strong rises in the overall market PE ratio, followed by a period during which corporate earnings growth has gradually risen, enabling the PE to return to a more normal level without undermining the bull market. The first phase is normally associated with easy liquidity conditions, while the second phase may see interest rates starting to rise. On this basis, the rallies since August last year, and the associated rise in PE ratios are presuming an improvement in liquidity conditions which has yet to occur. If the economy remains severely depressed and investors sense no prospect of improvements in earnings, then there is some risk that the stock market may fall. More probably, the Bank of Japan will be induced to lower interest rates once again, and thus ease monetary conditions -- actions which would support equities and bonds.

On a longer term basis, the outlook for the Japanese equity market depends crucially on the kind of PE multiple that investors are prepared to pay for Japanese corporate earnings. Since the economy is not likely to grow at much more than 3-3.5% p.a. in the 1990's, premium multiples cannot be sustained on the basis that Japan is a high-growth economy. The only basis for such high multiples is that government bond yields at 4.3% are lower than any other major country and imply a premium rating for PE ratios. In this sense, Japanese equities are acutely vulnerable to any rise in inflation and/or bond yields.

JAPAN: CHART 13
PRICE/EARNINGS RATIO



JAPAN: CHART 14
THE LEVEL OF PRODUCTIVITY FROM 1958 TO 1993



Section 2. Long-term Growth Prospects

Japan's longer term growth prospects depend on the potential for productivity growth and on the potential growth of the labour force. Labour productivity or output per manhour is normally calculated by an index of output divided by the product of an index of employment multiplied by an index of hours worked. For Japan, two consistent long-term series can be compiled:

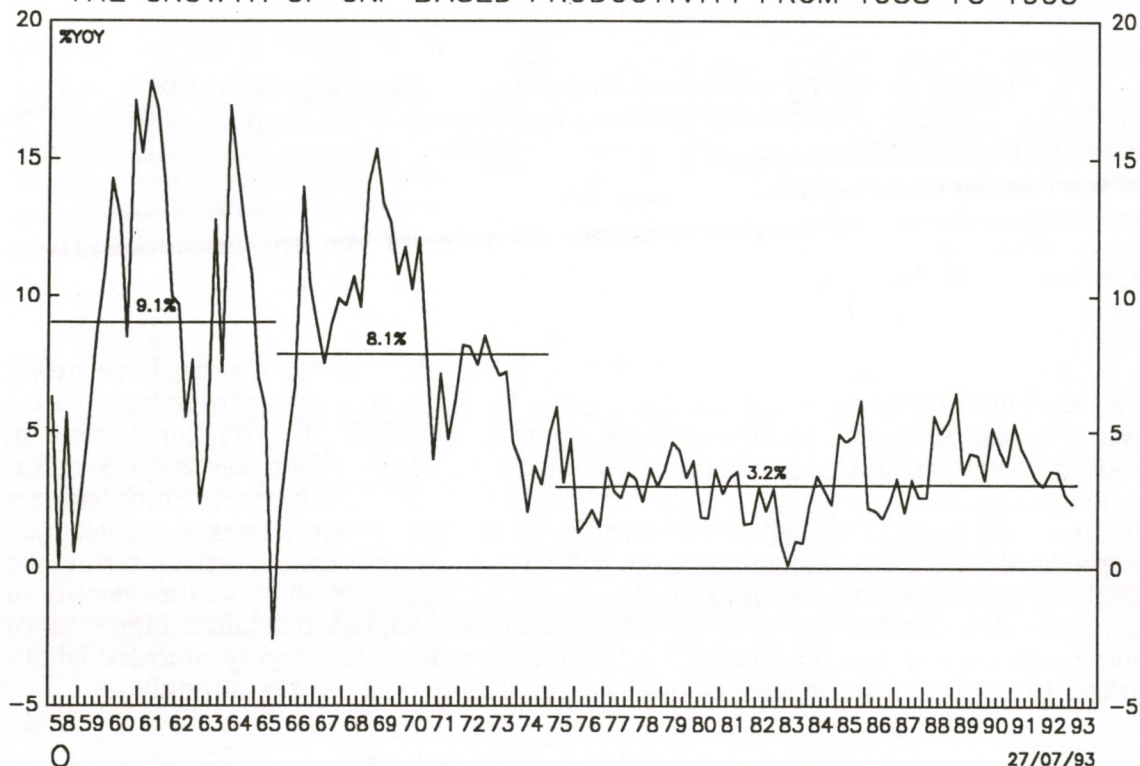
Real GNP/(Labour Force x Hours Worked), and Index of Industrial Production (IIP)/(Employment in Manufacturing x Hours Worked).

As shown in Chart 14, the levels of productivity for both these series have strong long-term upward trends, which broadly explains the rise in the standard of living in Japan over the past 35 years. Both series are cyclical, especially the IIP/Employment in Manufacturing because the numerator has fluctuated widely with the business cycle. Also, although Japanese firms have generally employed people on a lifetime basis which has kept the first component of the denominator stable, the number of hours worked has declined markedly in recessions, accentuating the volatility of both series. In general terms, the level of productivity in a country reflects two major inputs to production: the quantity of physical capital and the quality of human capital. As Japan has maintained high rates of investment growth over the past three or four decades and has a highly educated labour force, it is natural that the level of productivity should have risen so strongly.

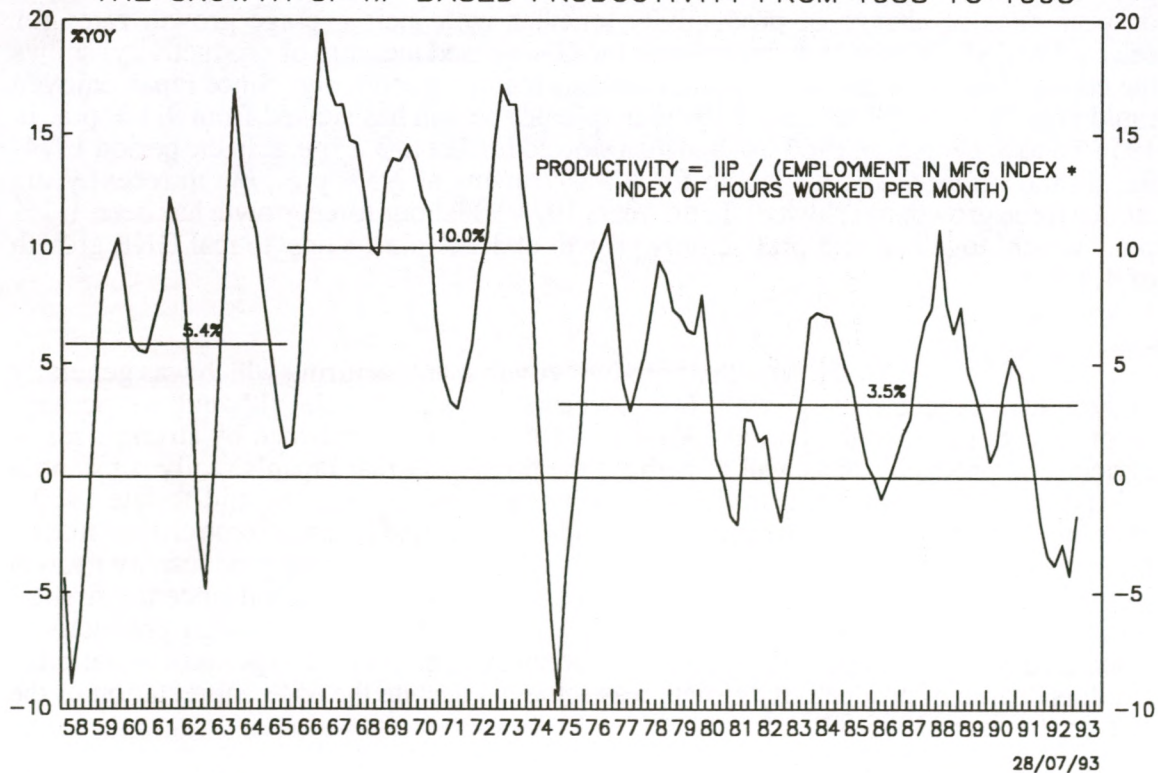
However, the rate of rise of productivity has been gradually slowing down over the past 35 years. This is more clearly evident in Charts 15 and 16 which show the year-on-year rates of change of productivity together with their average growth rates for selected periods. Chart 15 (which shows the GNP-based measure of productivity) shows the classic slowdown that one would expect in a maturing economy. Since Japan enjoyed rapid growth in the 1950's and 1960's, output per person has slowed from 9.1% p.a. in 1958-65 to 8.1% p.a. in 1966-74, and then slowed further to 3.2% p.a. in the period 1974-92. In the earlier years, the labour force was growing at 2-3% p.a., but in recent years labour force growth has slowed. In the years 1974-92 labour force growth has been 1.2% p.a., which, together with productivity growth of 3.2% p.a., sums to real GNP growth of 4.4% p.a.

Chart 16 features the growth of productivity in manufacturing which was generally higher than productivity growth for the economy as a whole although -- perhaps surprisingly -- not for the period 1958-64. (This could be explained by strong rises in agricultural productivity as well as perhaps the possibility that Japan's really substantial gains in manufacturing productivity did not start to show up until the mid-to-late 1960's after the level of capital investment in many industries started to reach some critical mass). Nevertheless, there has been a marked slowdown in manufacturing productivity growth from 10.0% p.a. in the period 1965-74 to just 3.5% p.a. in the period since the first oil crisis, 1974-92. The bubble years (1987-89) show up as a steep spike in productivity associated with the unsustainable investment boom of those years. It is perhaps remarkable that this degree of productivity growth was achieved despite the 85% appreciation of the Yen in the years 1985-87.

JAPAN: CHART 15
THE GROWTH OF GNP BASED PRODUCTIVITY FROM 1958 TO 1993



JAPAN: CHART 16
THE GROWTH OF IIP BASED PRODUCTIVITY FROM 1958 TO 1993



Looking ahead to the 1990's and beyond, the major change will be a shift to an absolute decline in the labour force compared with growth rates of around 1% p.a. in the 1980's. This will not restrain productivity growth per se, but it will mean that the trend rate of GNP growth (= productivity growth plus change in labour force plus change in hours worked) will slow. As shown in Table 1 below, the size of the Japanese eligible labour force defined as those between the ages of 15 and 64 is estimated to peak at 87,134,000 in 1995, and to decline steadily thereafter until 2025. Of course, it is possible that the labour force participation rate (i.e. those members of the 15-64 age group actively engaged in employment or seeking employment) could rise, but this seems unlikely. For example, it would require an increase in the participation rate from around 74% at present to as much as 87% just to maintain the current dependence ratio over the next 30 years. In other words, given the decline in the projected labour force due mainly to the ageing of the population, and given that each member of the labour force currently supports 0.94 persons who are not in the labour force, it will require a huge increase in the participation ratio to support the population of students, wives and retirees etc. at the same dependence ratio. The conclusion must be that Japan's real GNP growth rate will slow again during the 1990's and during the first two decades of the next century.

TABLE 1.
FORECAST OF JAPAN'S POPULATION AND ELIGIBLE LABOUR FORCE
(unit: thousands of persons)

YEAR	TOTAL	AGE 15-64	YEAR	TOTAL	AGE 15-64
1990	123,611	86,140	2008	130,135	82,341
1991	124,043	86,557	2009	130,296	81,656
1992	124,413	86,818	2010	130,397	81,304
1993	124,767	87,008	2011	130,441	81,083
1994	125,114	87,100	2012	130,426	80,125
1995	125,463	87,134	2013	130,353	79,113
1996	125,821	87,045	2014	130,222	78,137
1997	126,190	86,908	2015	130,033	77,404
1998	126,575	86,752	2016	129,790	76,851
1999	126,974	86,602	2017	129,496	76,437
2000	127,385	86,350	2018	129,154	76,139
2001	127,801	85,982	2019	128,769	75,955
2002	128,215	85,603	2020	128,345	75,774
2003	128,617	85,236	2021	127,886	75,645
2004	128,997	84,936	2022	127,398	75,580
2005	129,346	84,930	2023	126,885	75,460
2006	129,656	83,705	2024	126,353	75,286
2007	129,921	82,992	2025	125,806	75,118

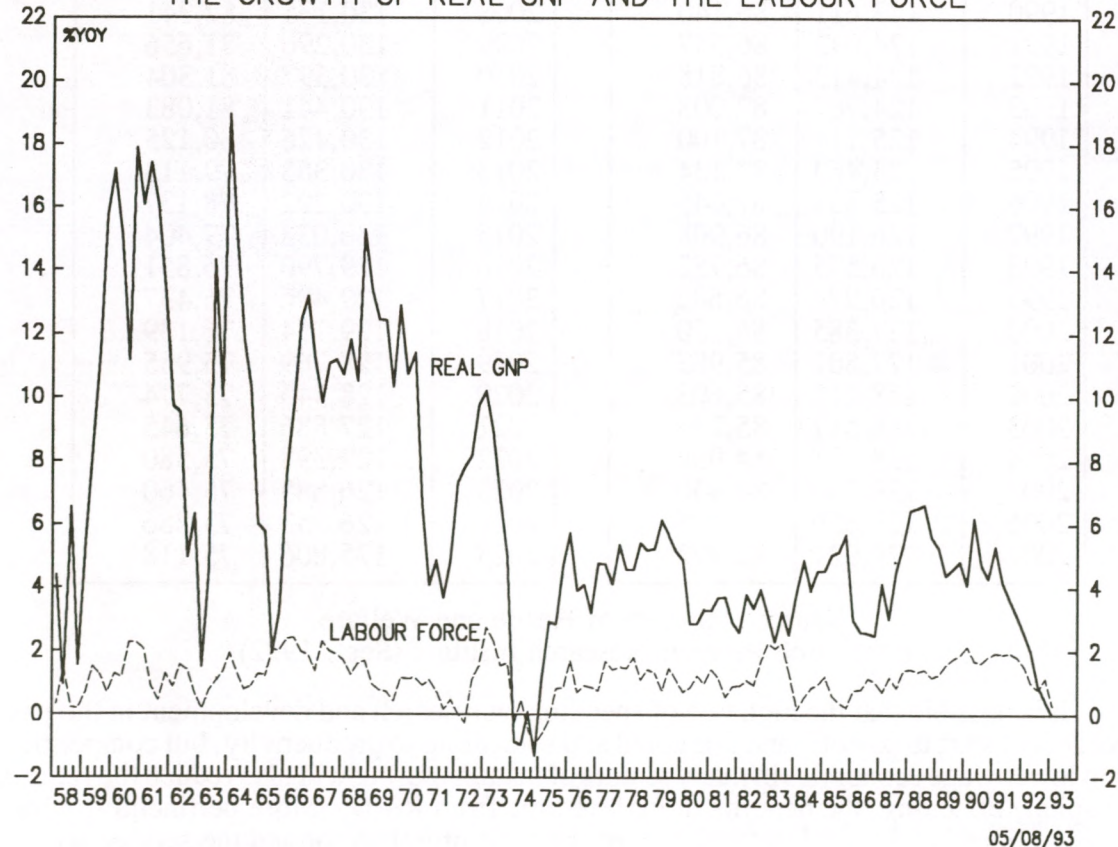
Source: Ministry of Health and Welfare.
Population Problem Research Institute (Sept. 1992)

It is possible that the high rate of spending on research and development in the past decade will start to pay off, and this could add something to productivity, but competition from lower wage economies in many sectors of manufacturing will also reduce the returns to capital, offsetting the benefits of high returns from R+D. More pertinently, wide-reaching liberalisation and deregulation of the agricultural sector and the service sector, either as a result of progress in the Uruguay round of the GATT negotiations, or as a result

of the accession to power of a non-LDP government which is less beholden to the agricultural lobby or to the small retail store interest groups, could contribute to productivity gains in these two important, but lagging, sectors. Reductions in agricultural and food prices in particular could play a critical role since Japanese families spend 26% of their budgets on food compared with only 14% spent by households in the USA. A reduction to just 20% would free up significant sums for expenditure on other consumer goods and services. Within the service sector, the following sub-sectors could benefit from liberalisation and deregulation (and hence productivity increases): finance, retail distribution, transportation and telecommunications.

In conclusion, the medium or longer term prospects for Japan's real economic growth rate will depend on maintaining a high growth rate in productivity since the growth of the labour force will cease to be a factor assisting Japanese GNP growth. The ability to sustain productivity improvements in turn depends on the country's ability to deregulate sectors which have over the past 20 years contributed rather little to Japan's overall increase in productivity. This is especially so since the productivity level in Japanese manufacturing is already so high (and therefore incremental gains will be difficult or costly to achieve), and many Japanese firms can be expected to transplant their assembly lines to other countries in Asia, Latin America or Eastern Europe which offer lower labour and land costs.

JAPAN: CHART 17
THE GROWTH OF REAL GNP AND THE LABOUR FORCE



SUMMARY AND FORECAST: Monetary factors are holding back Japan's short term or cyclical growth rate; slower growth of productivity and the labour force will continue to constrain Japan's longer term secular growth performance through the 1990's. On a cyclical basis, Japan's economy moved into recessionary conditions in late 1991 and has remained in a slow-growth mode since that time on account of the tight money policy (specifically the slow money growth rate) implemented and maintained by the Bank of Japan to deal with the "asset bubble" of the late 1980's. To recover from this sub-par growth rate to a more healthy growth rate will require more than either a mere inventory adjustment or a third fiscal spending package.

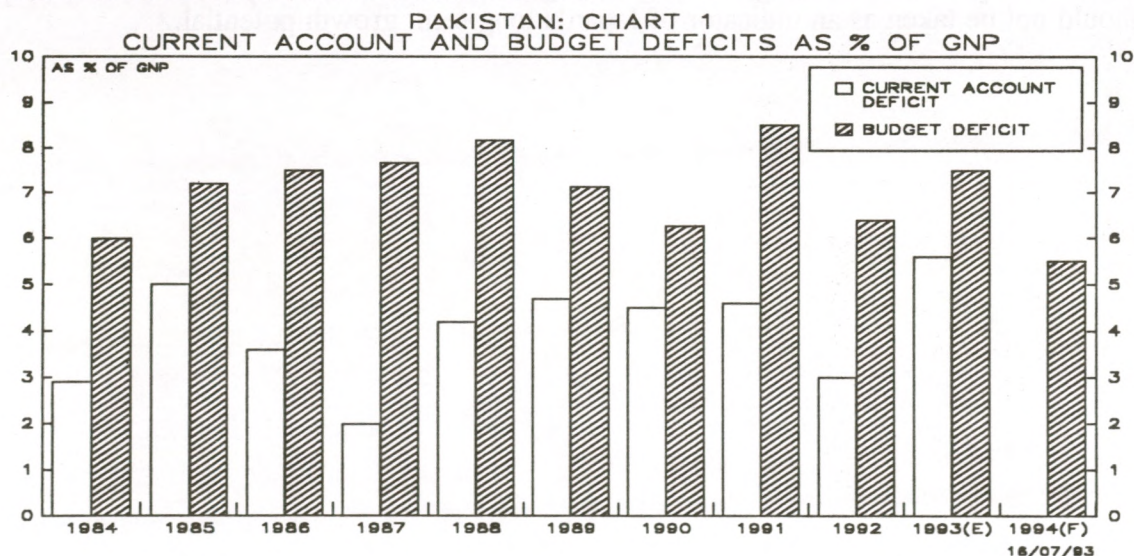
In the face of weakening exports -- resulting from the appreciation of the Yen and the persistence of weak demand overseas -- the GNP statistics are likely to show continued weakness through the rest of calendar 1993. In order to ensure a reasonable recovery in 1994 it is essential that the Bank of Japan eases the monetary reins further by lowering interest rates (the official discount rate and especially the key interbank call rate) a further notch or two, and thereby encourages or enables the banks to expand their lending, which in turn will permit the money supply to accelerate. Compared with its current growth rate of 2.5% year-on-year, Japan's M2 + CD's needs to accelerate to approximately 6% year-on-year to be sure of generating the growth in real purchasing power with stable prices needed to fuel a genuine and sustainable recovery.

On a longer term view, Japan's economic growth rate cannot be expected to maintain the pace experienced in the past 3 or 4 decades of post-war economic development; nor even the pace enjoyed in the 1980's. Not only has the economy already caught up with its leading industrial competitors in many fields of manufacturing, but some of the factors which enabled it to grow rapidly in the past (such as the growth of the labour force or the cheap and easy access to known technologies) will no longer be present. Only in the service sector and, to a lesser extent, in agriculture will large gains in productivity be feasible. The lower long term growth prospects for Japan in the 1990's and beyond will affect the investment environment only slowly, but they could be one of several factors causing a reassessment of the multiples that investors are willing to pay for Japanese earnings. In the event of a rise in interest rates or a renewed episode of inflation, such vulnerability would become clearly apparent. In the meantime, a short term recovery with some quarters of growth exceeding the long-term growth rate are entirely feasible, but they should not be taken as an indicator of Japan's long-term growth potential.

PAKISTAN A SHORTAGE OF DOMESTIC AND FOREIGN RESOURCES

The much touted concept of a global capital shortage may be a reflection of a global logic shortage (global savings must be equal to global investment), but a lack of capital can always afflict an individual economy. An acute sufferer is Pakistan where a shortage of domestic savings is exacerbated by an inability to draw on foreign capital. In recent years, Pakistan has put in place one of Asia's most radical and far-reaching economic reform programmes but for a variety of reasons it has failed to attract significant sums of overseas investment. Political machinations, domestic unrest and (unjustified) fears of rising Islamic fundamentalism have all served to keep foreign investors away, and have overshadowed the economic attractions. It is fair to assume that these issues will not disappear in the near future, so in the absence of an improved external image, domestic resource mobilisation will have to play the lead in closing Pakistan's savings/investment gap.

At the time of writing, the man behind the country's reform programme, prime minister Nawaz Sharif, has just resigned and called fresh elections. Mr. Sharif has, in recent months, been sacked by President Ghulam Ishaq Khan (who has also offered his resignation), reinstated by the Supreme Court, and contended with state parliament dissolutions, and an opposition campaign employing the use of mass action to get him to stand down. To date the army has distanced itself from the whole unseemingly process, but its eventual intervention cannot be ruled out if the transition period between now and the election does not go smoothly. Not surprisingly, economic reform has been given rather less priority in the current environment and this can in part explain the disappointing budget presented in May. Finance Minister Aziz presented a rather bland package to try and close Pakistan's unwieldy budget deficit (Chart 1). The deficit expanded way beyond its target of 4.8% of GNP during fiscal 1992-93 (to June), and will probably end up at around 7.5% of GNP. For 1993-94, the target has been set at 5.5% of GNP. Such a reduction should be enough to satisfy the IMF and other international donors, but the savings are to be made by increasing taxes. This is in itself a sensible strategy given the intractable nature of a large portion of the government's expenditures (debt service is set to eat up 37% of expenditures and defence a further 27% during 1993-94), but efforts should be concentrated more on direct taxation.



Pakistan's low tax yield is reflected in its low savings rate (by Asian standards) which is insufficient to fund the investment needs of a developing nation. A flow of funds identity states that

$$\text{TOTAL SAVINGS (ST)} - \text{TOTAL INVESTMENT (IT)} = \text{CURRENT ACCOUNT BALANCE (CA)}$$

If savings exceed investment, the country will run a current account surplus, but if investment cannot be funded from domestic savings, then a current account deficit will ensue. The savings/investment side of the equation can be further broken down into private and public sector components.

$$\text{ST} = \text{PRIVATE SAVINGS (SP)} + \text{GOVERNMENT SAVINGS (SG)}$$

where SG is the surplus of government revenues over current expenditure, and

$$\text{IT} = \text{PRIVATE INVESTMENT (IP)} + \text{GOVERNMENT INVESTMENT (IG)}$$

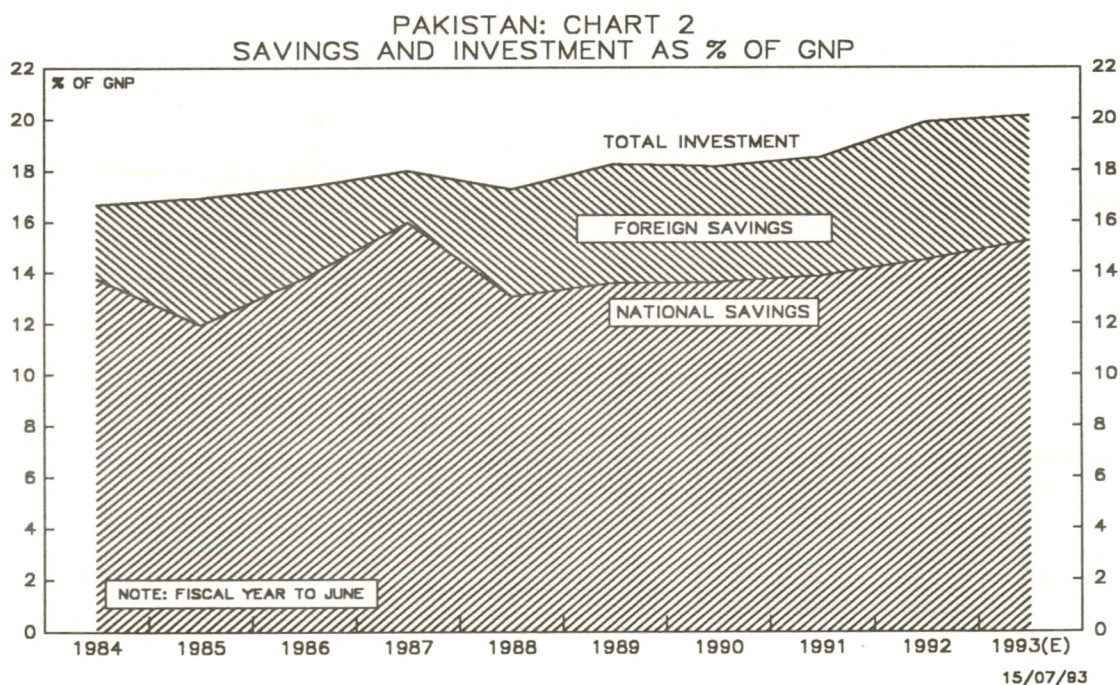
so,

$$(\text{SP} - \text{IP}) + (\text{SG} - \text{IG}) = \text{CA}$$

It therefore follows that as the current account deficit in Pakistan (an estimated 5.7% of GDP during 1992-93) is less than the government budget deficit (Chart 1), that private savings are more than sufficient to fund private investment.

$$(\text{SP} - \text{IP}) = \text{CA} - (\text{SG} - \text{IG}) \text{ or } 1.8\% = -5.7\% - (-7.5\%)$$

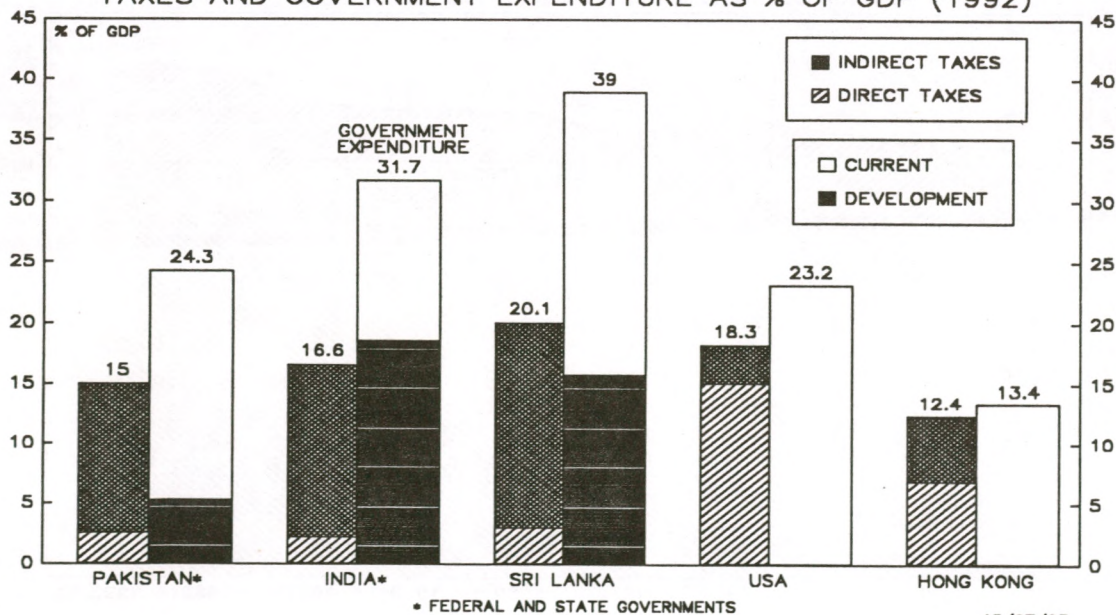
However, as the government continues to run a budget deficit larger than the private sector savings surplus, overseas savings are required to fund the gap (Chart 2).



Trimming the budget deficit by raising taxes may not necessarily result in a lower current account deficit, as the extra tax payments may come out of funds that would otherwise be saved. However, there is reason to believe that this might not be the case if more of Pakistan's huge parallel economy (estimated at 30-50% of GNP) could be brought into the official figures. The authorities have tended to concentrate their revenue raising efforts on indirect taxes but there are signs that these are now becoming inelastic. For example, the raising of the excise duty on telephone calls last year, led to a 60% fall in revenue. Nevertheless, of the Rupee 22 billion extra to be raised during 1993-94, Rupee 17 billion will come from indirect taxes and 4 billion from improved collection, with only Rupee 1 billion from direct taxes. The political will is lacking in a country where only 1 million people (out of 120 million) and 10 listed textile companies (out of 200) pay income and corporation tax, and where no-one has ever been convicted of tax evasion. Indirect taxes may be easier to administer and collect but they tend to be regressive and ultimately to become inelastic. It would be better to improve incentivisation for tax collectors, make a few high-profile arrests and offer the collection of lump sum payments in return for no audits. Unfortunately, this will require a government that is willing to take on the vested interests, which in turn implies that impoverished politicians, bureaucrats and army personnel may have to start paying their shares.

The scale of the problem becomes clear if one compares taxes and government expenditure across countries (Chart 3). (The gap between the two is not equal to the total budget deficit as non-tax revenues, grants and aid are not shown.) Pakistan's mix of direct and indirect taxes is similar to that of other countries in the subcontinent, but its problems are more acute. Sri Lanka and India have been able to rely much more on aid flows so expenditures on much-needed infrastructure have been squeezed less. (Sri Lanka has the same problems of high defence and debt service expenditures.) Assuming, therefore, that aid flows to Pakistan do not accelerate, tax revenues must be boosted to help finance infrastructure projects. (Of course it would be preferable to get the private sector to build the roads and power stations, and to fund health and education programmes. However, this seems unlikely in the near future.)

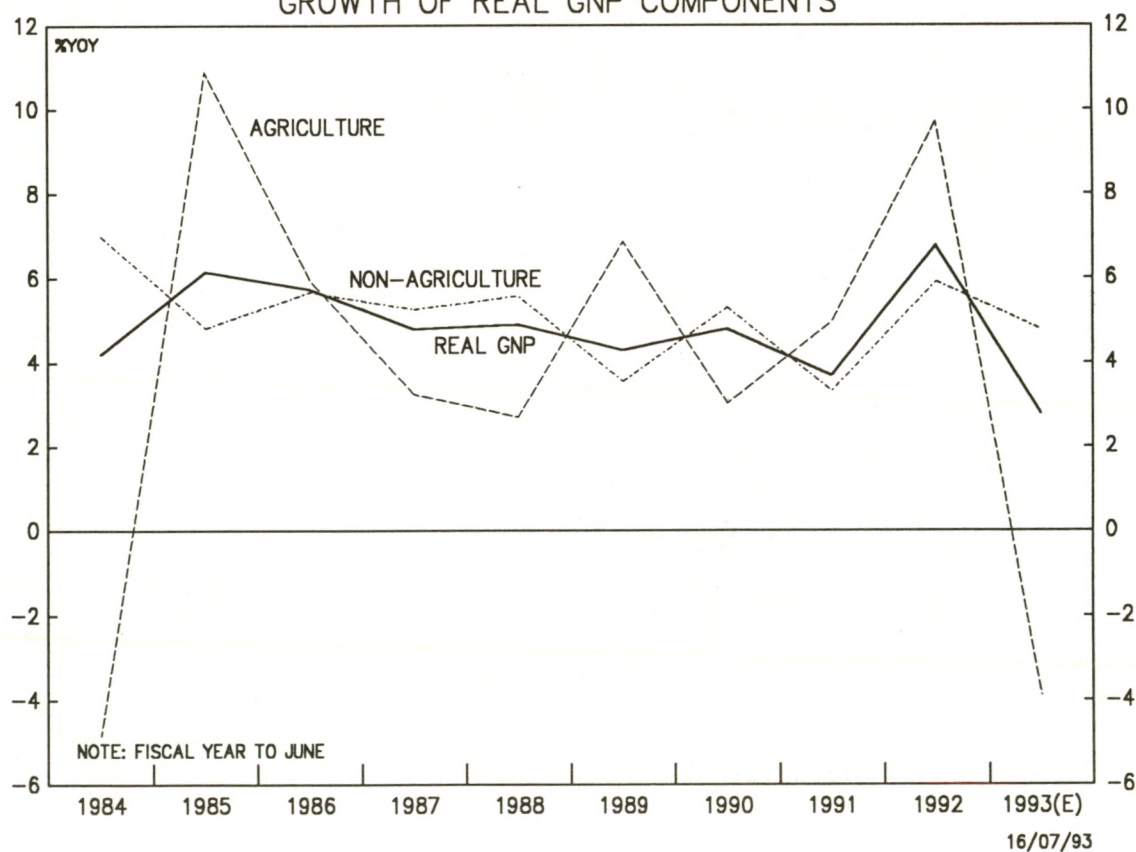
PAKISTAN: CHART 3
TAXES AND GOVERNMENT EXPENDITURE AS % OF GDP (1992)



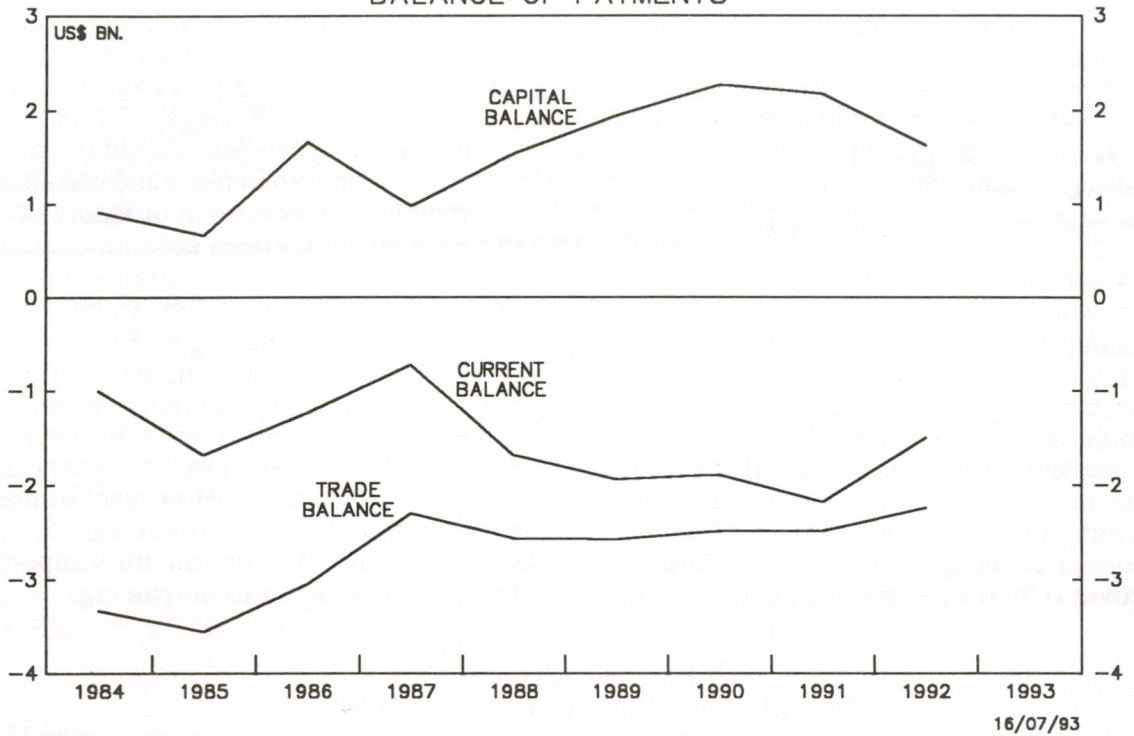
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The budget deficit in Pakistan should fall as a percentage of GNP this year, because economic growth will be relatively strong. Last year's floods resulted in a real 3.9% contraction in agriculture and cost an estimated US\$2.2 billion in lost production and infrastructure. This pulled real GNP growth down to only an estimated 3% in the year to June 1993 (Chart 4). Growth should rebound to at least 6% in 1993-94 as agriculture recovers, although it will probably fall shy of the government's 7.7% target. Domestic investment, has grown a real 10% on average over the last two years and should remain strong. Domestic consumption has also responded to the reforms put in place and can also be expected to grow rapidly. However, the all important textile sector will probably not fare as well. The powerful growth of this area in recent years has been accommodated by previously unutilised quotas. Pakistan is now nearing these limits so future export growth may be capped by US and EC policy. Under the Multi Fibre Agreement, for example, US textile quotas are set to rise only 7% per annum. All this argues for further upgrading and diversification of the manufacturing base, which leads one back to the problem of a lack of capital. Unless Pakistan can manage to boost domestic resource mobilisation, the budget deficit and by implication the current account deficit will remain excessive. Foreign capital inflows should pick up somewhat over the next few years as the country's undoubted potential becomes more widely appreciated. However, in the short run, the balance of payments will continue to constrain the economy (Chart 5) -- foreign exchange reserves are now around US\$400 million or less than one month's import cover (Chart 6) -- and the authorities will have to resort once again to borrowing.

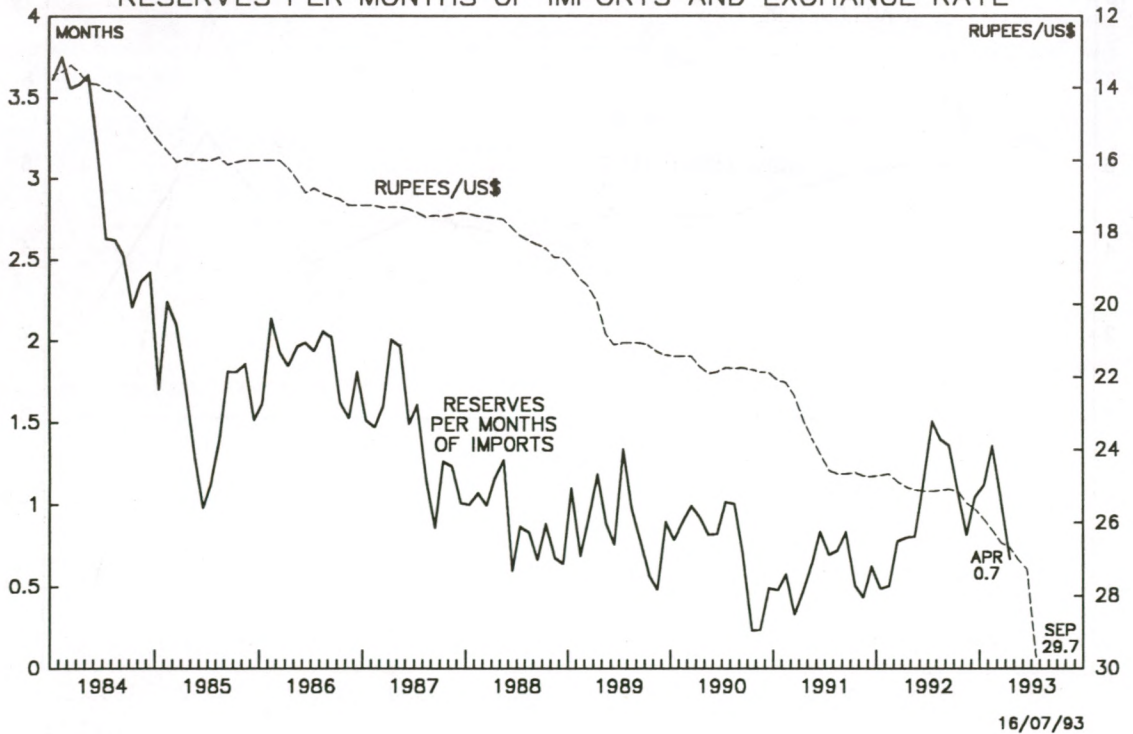
PAKISTAN: CHART 4
GROWTH OF REAL GNP COMPONENTS



PAKISTAN: CHART 5
BALANCE OF PAYMENTS



PAKISTAN: CHART 6
RESERVES PER MONTHS OF IMPORTS AND EXCHANGE RATE



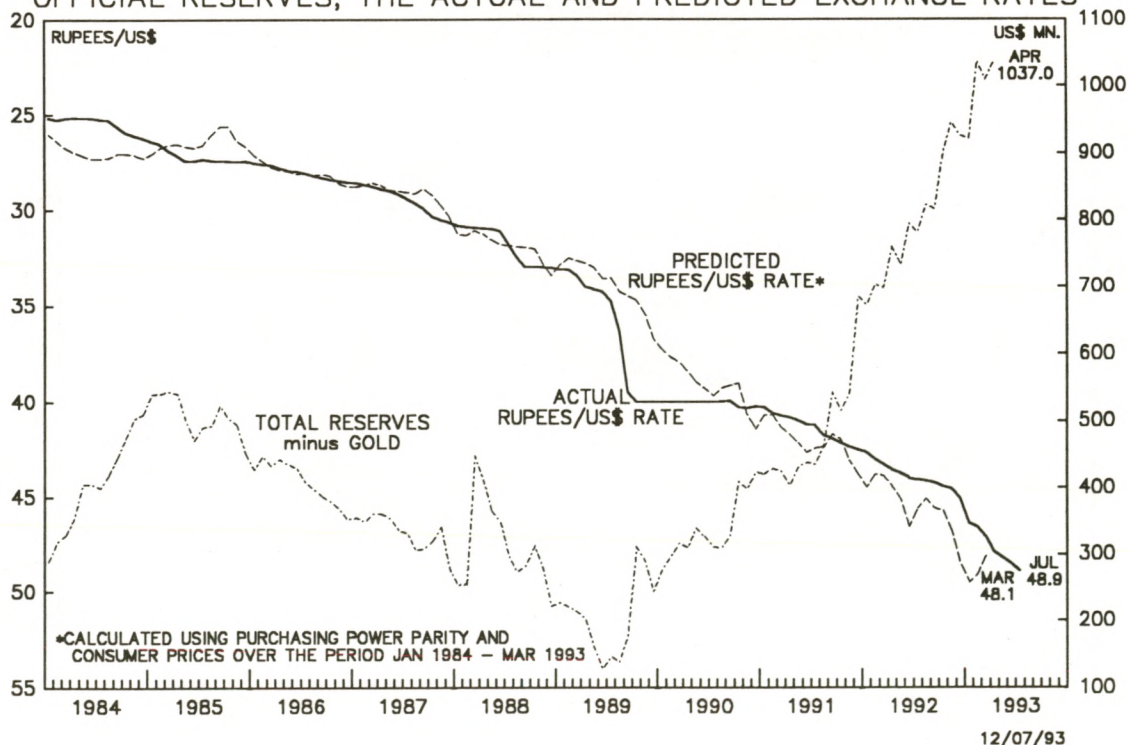
SRI LANKA THE CASE FOR CAPITAL ACCOUNT EXCHANGE RATE CONVERTIBILITY

Introduction

In March 1993, Sri Lanka followed the example of India and made the Rupee fully convertible on current account (i.e. trade) transactions. In retrospect it seems strange that the subcontinent's premier reformer delayed for so long before taking this step. However, fears of balance of payments weakness and a desire to maintain full control of the currency had held the authorities back. Two factors prompted the change in policy. First, foreign exchange reserves had been rising since 1989, and stood at almost US\$1 billion or 3 months' of import cover by the end of 1992 (Chart 1). Second, the sight of India -- the great, reactionary neighbour of old -- successfully introducing currency reform came as a shock to the system and acted as a catalyst. Although current account convertibility is to be welcomed, in reality it will mean little change in the way Sri Lanka conducts its foreign exchange policy. This in turn implies that inflation will remain uncomfortably high. The bureaucrats argue that depreciation is necessary to maintain competitiveness but for a small open economy reliant on imports, such a policy can be self-defeating as gains in competitiveness are rapidly inflated away. This article argues that a better alternative would be to run a stronger exchange rate policy which may result in a short run loss of competitiveness, but longer term should mean lower domestic inflation and an associated improvement in export price inflation. Such a policy would be facilitated by the further relaxation of controls on capital account transactions.

SRI LANKA: CHART 1

OFFICIAL RESERVES, THE ACTUAL AND PREDICTED EXCHANGE RATES

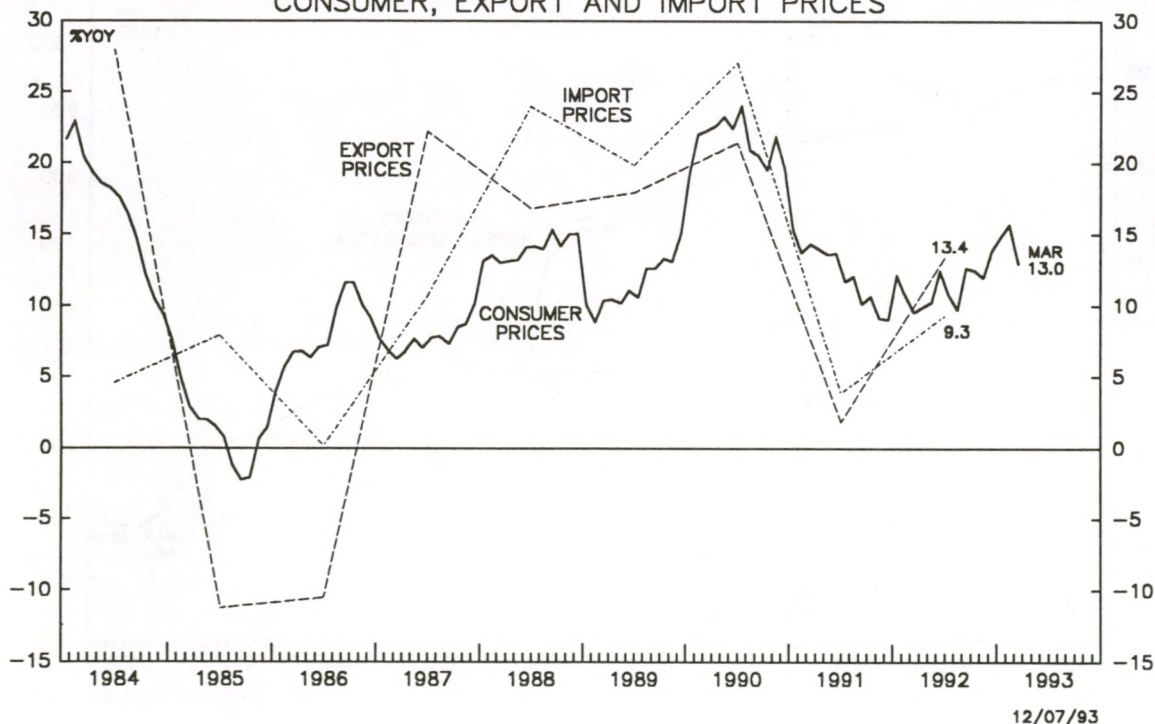


Inflation

At the end of March 1993, consumer prices were rising at 13% yoy and were seemingly trending upward. The whole gamut of explanations for Sri Lanka's persistently high inflation has been offered -- cost push, demand pull et al -- but the problem boils down to a monetary policy that both fuels domestic and accommodates imported inflation. Consider the following simplified transmission mechanism. The Sri Lanka Rupee depreciates 10% against the US dollar so *ceteris paribus* the Rupee cost of dollar imports rises 10%. Producers and retailers decide that they can pass on these price rises and this in turn leads to higher wage demands from consumers. Higher import costs are thus transmitted through into higher consumer and export prices. Exporters wish to maintain competitiveness, however, so the exchange rate is depreciated again leading to another round of price rises. Of course the transmission mechanism is neither instantaneous nor parallel (consumer prices may rise more than import prices, for example), but it characterises small, open economies like Sri Lanka reasonably accurately.

Simple observation confirms these ideas. Import, consumer and export prices have tended to move in tandem over time (Chart 2), although export prices are liable to distortion if, as in 1985 and 1986, the world tea price moves sharply. The correlation between changes in import prices and the CPI (between 1981 and 1992) is 49.5% while the CPI and export prices have a correlation of 61.4%. Export and import price movements have a 39.8% correlation. In fact the CPI basket poorly reflects the structure of Sri Lanka's imports but the knock-on effects of higher import prices seem to come through in higher consumer prices. The CPI has not been re-weighted since 1952 and has a 61.9% food weighting. Imports of food were only 12.1% of total imports in 1992, although these imports included such staples as rice and sugar which help form inflationary expectations. The links between the different inflation measures seem to be becoming even firmer over

SRI LANKA: CHART 2
CONSUMER, EXPORT AND IMPORT PRICES



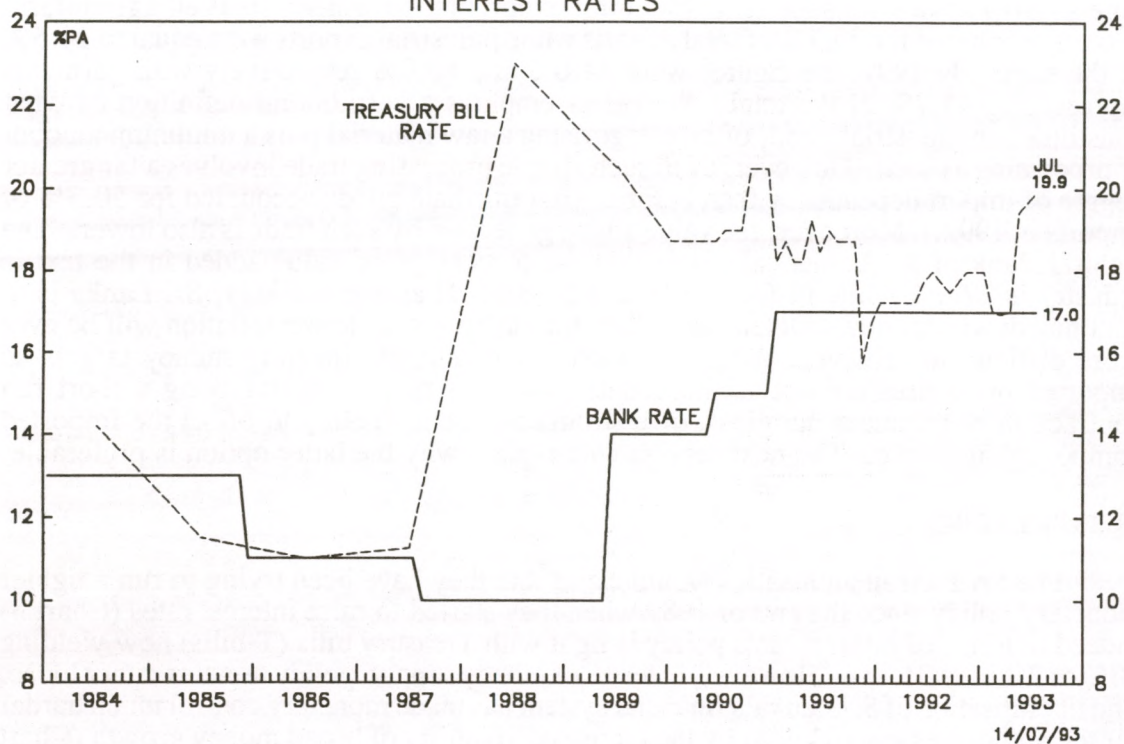
time as Sri Lanka's reliance on agricultural exports falls further. In 1980 agricultural exports accounted for 70.7% of total exports while industrial exports were equal to 24.5% of the sum. By 1992, the figures were 24.0% and 68.9% respectively with garments representing 44.7% of the total. Sri Lanka employs a very liberal definition of what constitutes an industrial good, often categorising a raw material plus a minimum amount of processing as such. However, even such simple processing trade involves a far greater degree of import dependency than before. (Intermediate goods accounted for 50.3% of imports in 1992.) Moreover, the value added generated by such trade is also lower. The Central Bank of Sri Lanka calculates that the percentage of value added in the textile industry is 27.1% while in foodstuffs it is 50.8%. If as seems likely, Sri Lanka is to continue down this development path, then the stated aim of lower inflation will be ever more difficult to achieve. What is needed is either lower quantity money targets so imported price rises are not accommodated and thus passed on (implying a short run contraction of producer margins), or a stronger currency policy to offset the imported component at source. The next section will explain why the latter option is preferable.

Monetary Policy

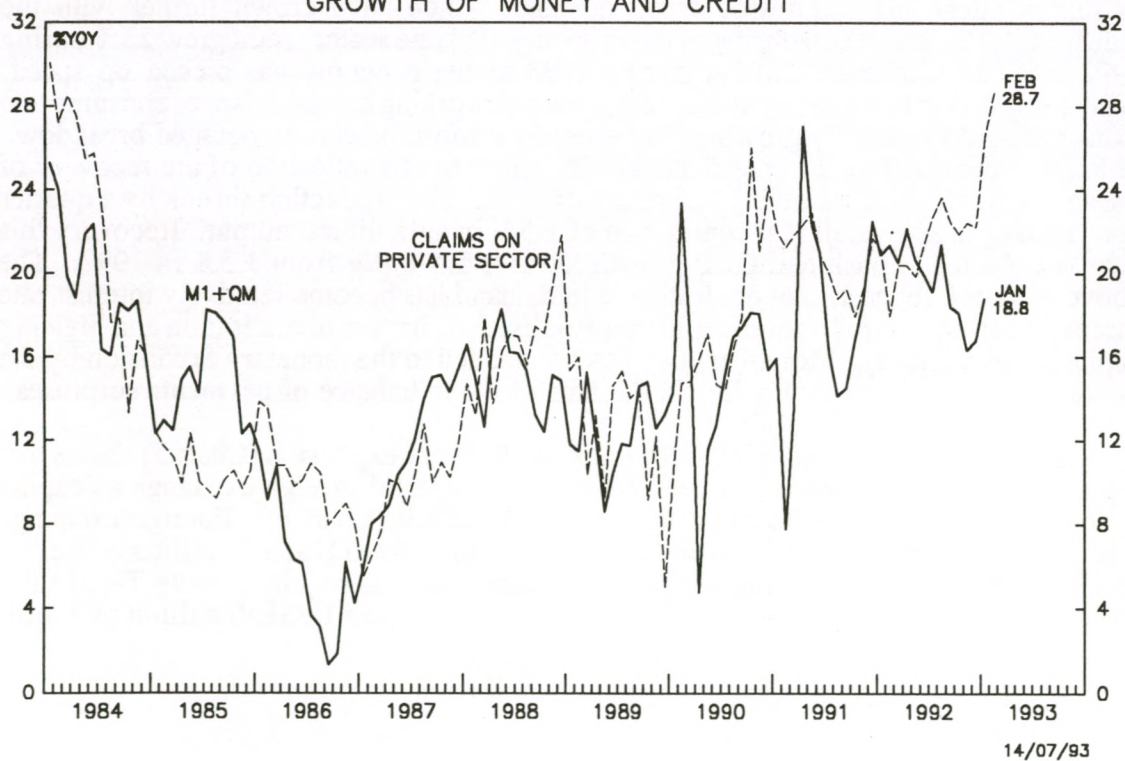
The Sri Lankan authorities would claim that they have been trying to run a tighter monetary policy since the end of 1989 when they started to raise interest rates (Chart 3). Indeed in terms of interest rates policy is tight with Treasury bills (T-bills) now yielding 20% or 7% in real terms. However, in terms of money supply, policy remains rather loose. The liberalisation of Sri Lanka's financial system has made monetary control much harder for the authorities as evidenced by the increased volatility of broad money growth (Chart 4). In recent years, priority and subsidised lending has been all but eliminated, credit ceilings have been abolished and interest rates have been freed. This has allowed banks to supply latent and suppressed credit demands which have grown further with the industrialisation and restructuring of the economy. Private sector credit grew 23% during 1992 and has accelerated further during 1993 as the economy has picked up speed. Whereas last year demand was mainly for trade and working capital finance, consumption loans are now supposedly growing very strongly (unfortunately, no detailed breakdown of loans is provided by the central bank). This in turn is a reflection of the recovery of the agricultural sector following last year's drought. Tea production shrunk by a quarter contributing to an overall real contraction of 1.5% in agricultural output. Recovery this year is expected to push real GDP growth towards 5.5-6.0% from 4.3% in 1992. The above evidence suggests that domestic credit demand has become relatively interest rate insensitive in an environment of rapid industrialisation, import liberalisation and high per capita income growth. Moreover, fuel has been added to the monetary expansion by the pursuit of a cheap currency policy in the face of rising balance of payments surpluses.

Examination of the sources of Sri Lanka's monetary expansion (Chart 5) shows that since 1989, the central bank has been a consistent buyer of foreign exchange as capital inflows have more than offset the current account deficit (Chart 6). Foreign exchange reserves have risen from US\$250 million at the end of 1989 to US\$880 million at the end of 1992. With domestic credit demand also strong, this has required heavy T-bill sales by the central bank. At the end of 1989, the central bank held US\$850 million of T-bills

SRI LANKA: CHART 3
INTEREST RATES



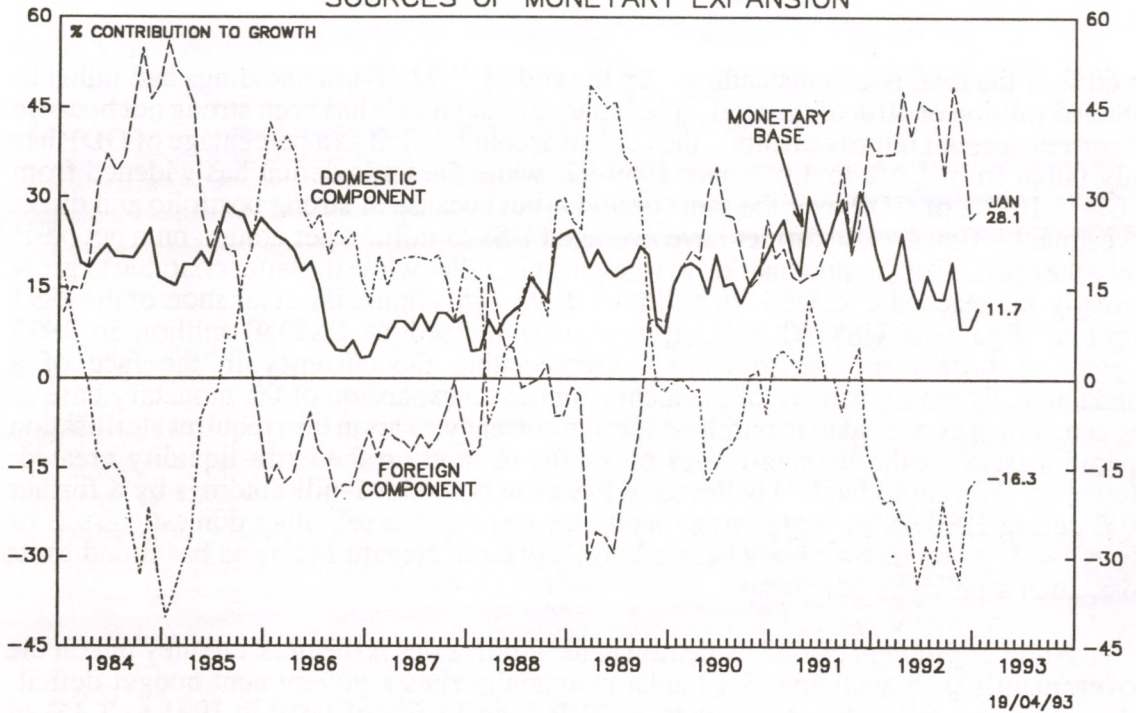
SRI LANKA: CHART 4
GROWTH OF MONEY AND CREDIT



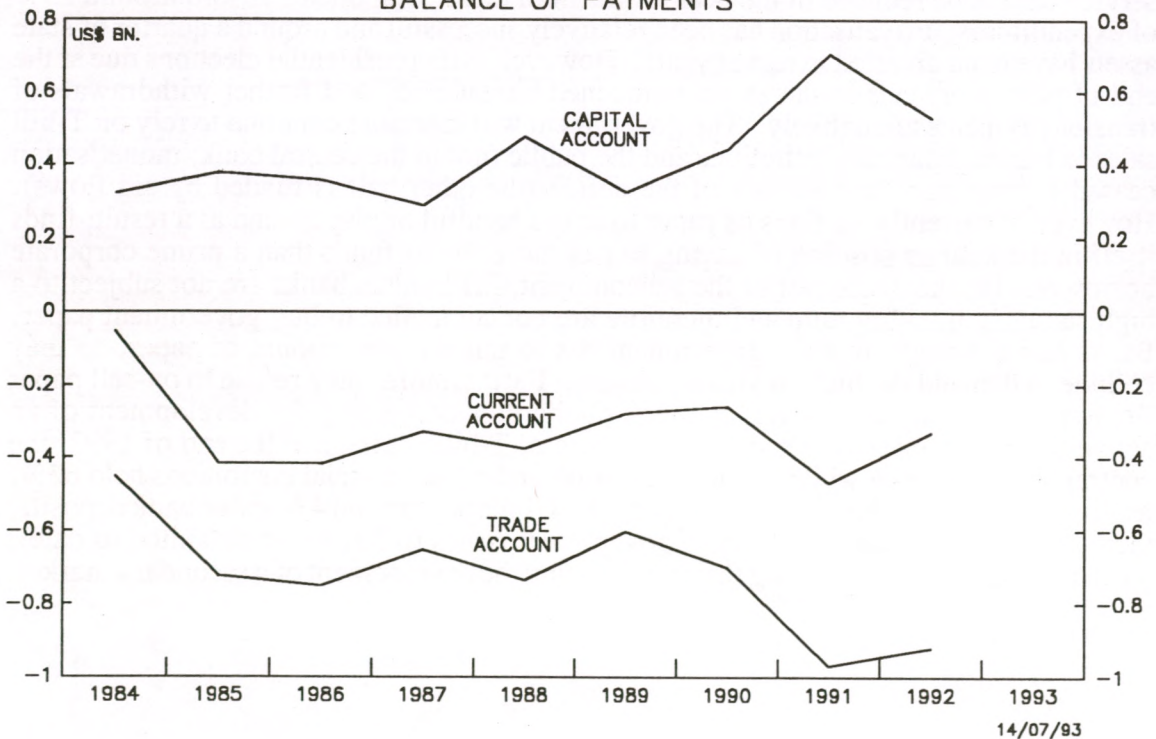
or 60% of the total issue outstanding. By the end of 1992, T-bills holdings had fallen to US\$565 million or 30% of the total. The balance of payments has been strong not because of current account improvements -- the current account deficit as a percentage of GDP has only fallen from 4.4% to 3.6% over 1989-92, while the trade deficit has widened from 9.6% to 10.0% of GDP over the same period -- but because of strong portfolio and direct investment inflows. The former have averaged US\$25 million per annum on a net basis since the opening of the stockmarket to foreigners in 1990, while the latter continue to grow strongly and reached a net US\$120 million in 1992. This figure is not far short of the 1991 approval figure of US\$180 million; approvals jumped to US\$380 million in 1992 suggesting further inflows to come. Depreciating the currency in the face of a fundamentally strong balance of payments implies an expansion of the monetary base as the central bank undertakes to purchase foreign currency. This in turn requires sterilisation operations via (at the moment) sales of T-bills to mop up the extra liquidity created. However, the central bank is believed to have run down its T-bill holdings by a further 40% during 1993 so far, suggesting that it may be forced to sell other domestic assets or issue liabilities on its own book before long. As Bank Negara Malaysia has found to its cost, such a policy is not cheap.

Another problem caused by central bank T-bills sales is the pressure they put on the government's own auctions. Sri Lanka perennially runs a government budget deficit. Although it has fallen as a percentage of GDP from 11.6% of GDP in 1991 to 7.4% of GDP in 1992 (and from 15.6% of GDP in 1988), most of the easy savings have now been made. Defence spending will remain high while the Tamil insurrection continues and debt service cannot be reduced in the near term. Both these components absorb around 25% of expenditures. Privatisation has been relatively successful and around a quarter of state assets have been divested in recent years. However, with presidential elections due at the end of next year, cuts in the as yet untouched bureaucracy and further withdrawals of transfer payments are unlikely. The government will therefore continue to rely on T-bill sales to banks, financial institutions and the public (not to the central bank; monetisation ceased 4 years ago) to fund half of the deficit (the other half is funded by aid flows). However, it currently auctions its paper to only a handful of players and as a result, finds itself in the strange position of having to pay more for its funds than a prime corporate borrower. Unlike in the rest of the subcontinent, Sri Lankan banks are not subject to a high statutory liquidity ratio and therefore are not compelled to buy government paper. Banks know though, that the government has to sell a given amount of paper, so they collude to demand the highest yields possible. Furthermore, they refuse to on-sell paper (in significant amounts) to the non-bank public thus preventing the development of an active secondary market. Of the US\$2 billion of T-bills in issue at the end of 1992, the central bank held 30% while commercial banks and other financial institutions held 62%, leaving just 8% in the hands of individuals. As T-bills pay around 4% above bank deposits, then assuming no general distrust of government issues (it has never defaulted to date), it can only be bank stonewalling that is preventing the development of a secondary market.

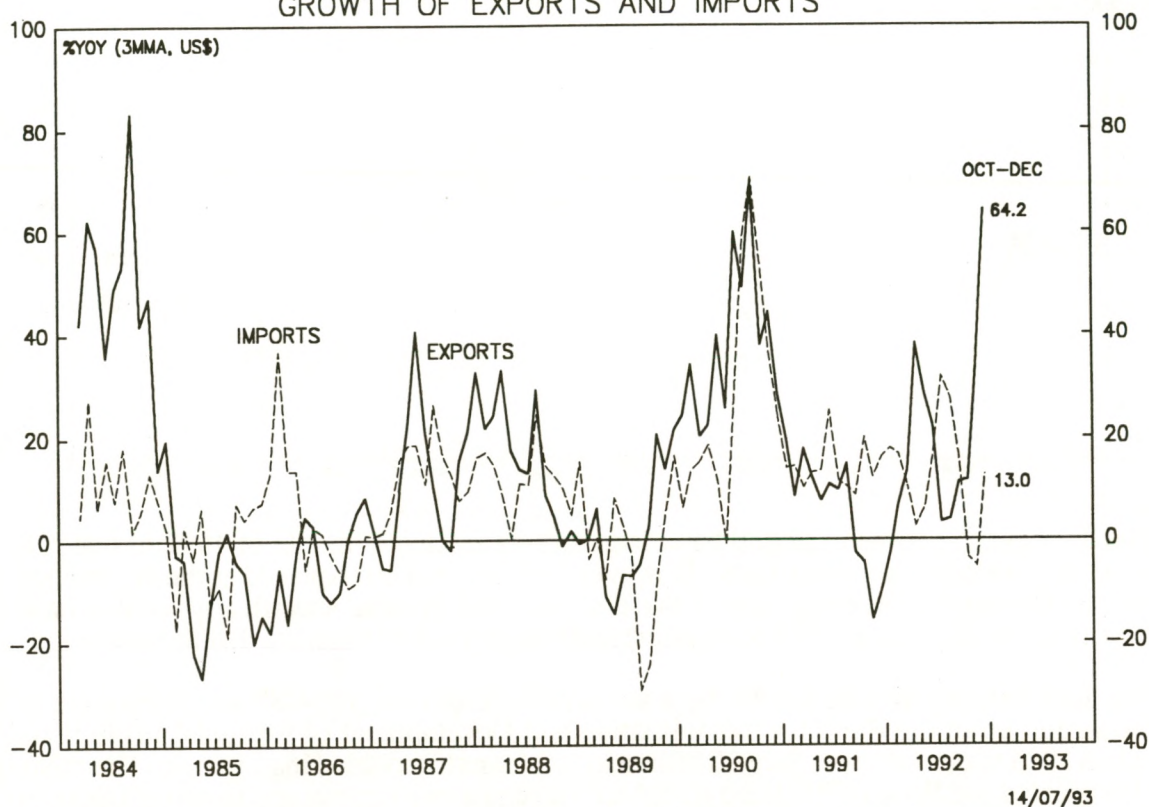
SRI LANKA: CHART 5
SOURCES OF MONETARY EXPANSION



SRI LANKA: CHART 6
BALANCE OF PAYMENTS

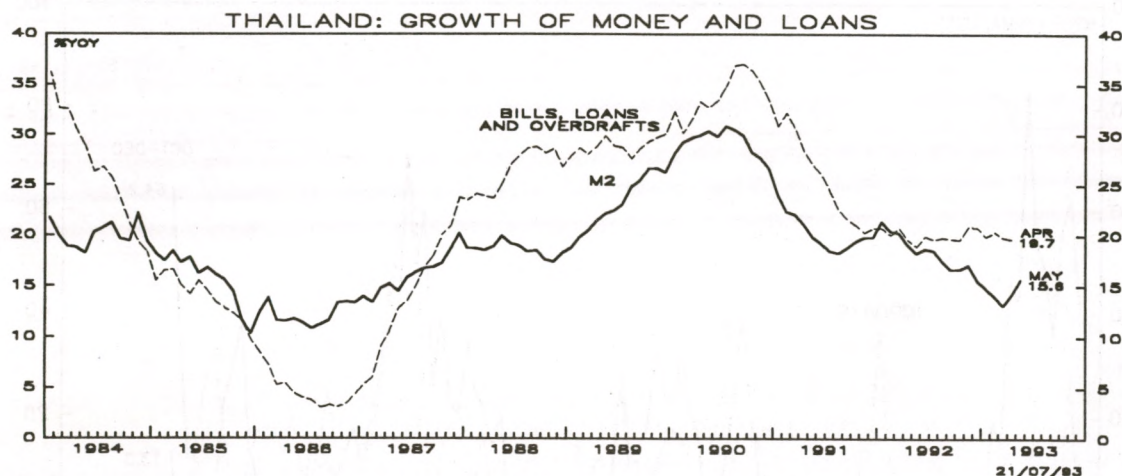


SRI LANKA: CHART 7
GROWTH OF EXPORTS AND IMPORTS



CONCLUSION: Clearly large central bank sales of T-bills are not helping the government to achieve lower borrowing costs in the face of the banks' cartel. It is therefore necessary to introduce more competition into the auction system which could best be achieved by opening up the market to foreign investors. Such a policy can only be implemented, however, if the central bank stays out of the foreign exchange market and allows the currency to appreciate in line with demand. Contrary to the fears of the authorities, further liberalisation of the capital account of the balance of payments, will not result in large scale capital flight. Those residents who want to transfer funds out of the country will for the most part, have already done so a long time ago. Indeed given the attractiveness of domestic yields, an inflow is more likely. The experience of the Philippines in recent years is a good illustration. Following the opening of the T-bill market to foreigners, the Peso strengthened as capital flowed in to chase yields of 22%. The Peso only started to weaken again when yields had dropped to under 12%. Certainly there was no flight following the extension of capital account convertibility. Even Pakistan which has had a fully convertible currency since February 1991 has seen no capital flight, although inflows have been minimal. Sri Lanka, is arguably more attractive than either country. Floating the currency upward would also help to choke-off imported inflation and the resulting knock-on effect into consumer and export prices. In the short term this may lead to a squeeze on producer margins and/or a loss of competitiveness, but as domestic price rises abate, so should export price rises. With dollar exports growing at 64.2% yoy at the end of 1992 (Chart 7), a temporary loss of competitiveness is probably tolerable if it results in lower inflation and reduced government borrowing costs.

THAILAND: THE MONEY AND LOAN GROWTH DIVERGENCE EXPLAINED



The divergence between M2 and bank loan growth since the middle of 1992 has been a cause for concern in some quarters. However such concern is misplaced as the divergence reflects the ongoing development of the Thai financial system; specifically, capital base expansion, an increase in offshore funding and a faster pace of financial disintermediation.

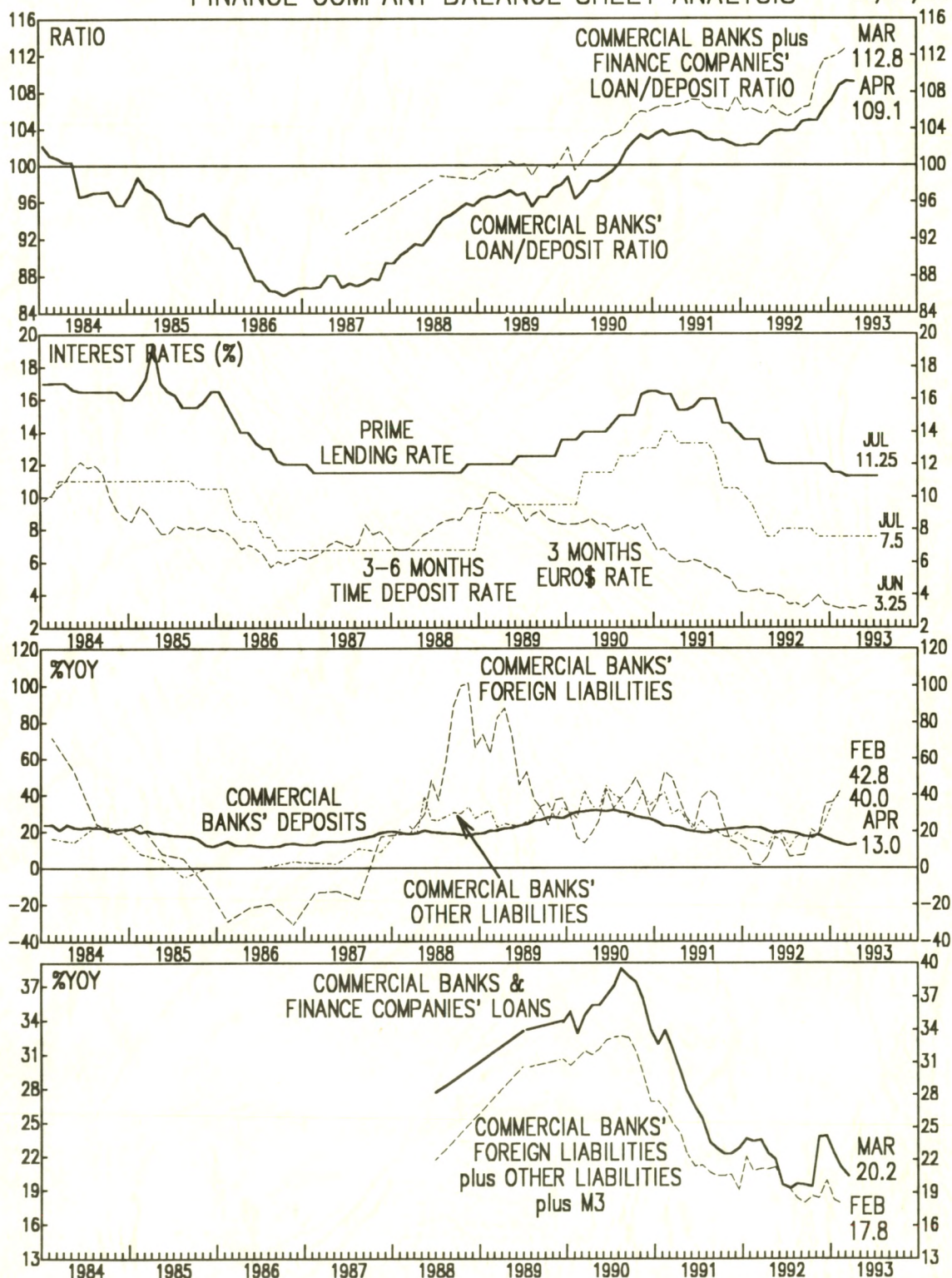
The Thai banking system was hit by a series of failures over 1984-87 which resulted in the setting up of the Fund for Rehabilitation and Development of Financial Institutions in late 1985 to provide over Baht 20 billion in soft loans to troubled institutions. The crisis also spurred the Bank of Thailand to tighten its regulatory regime and to direct banks to strengthen their capital bases. Since 1987, Thai banks have increased their capital by an average of 24% per annum. The three major components of a bank's balance sheet are, on the liability side, capital and deposits, and on the asset side, loans. Thus raising capital allows loans to grow faster than deposits and is reflected in a rising loan/deposit ratio.

However, capital raising alone cannot explain the widening gap since the middle of 1992. In a quasi-fixed exchange rate regime, Thai banks have found it very profitable to borrow offshore (at low interest rates) and on-lend in the domestic market. Thus foreign liabilities, which are not included in M2, have surged. (Note how the even stronger surge in foreign liabilities early 1988 was also reflected in an M2/loan growth divergence.) At the same time, the growth of "other liabilities", which mainly consists of accrued expenses, has also been rising strongly, probably reflecting the increasing cost bases of banks.

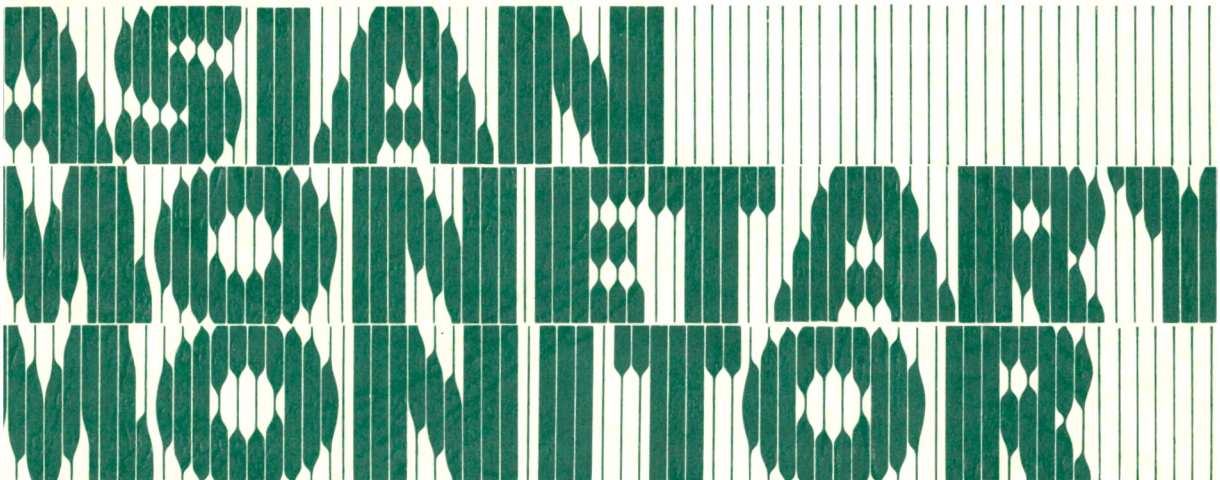
The final missing piece in the puzzle concerns the relatively strong growth of deposits at finance and securities companies over the same period. Interest rates started to fall in Thailand in late 1991, but the rates offered by finance companies have remained consistently higher than bank deposit rates. Hence, there has been a switch of deposits away from the banks which has tended to be magnified in times of stockmarket strength (for example, at the end of 1992). If one consolidates M2 plus finance company deposits (=M3) plus banks' foreign and other liabilities, and compares its growth rate with that of bank and finance company loans, then the figures appear to be much in line. What is clear is that money growth and loan growth remain steady in the 17-21% range, and that the 2-3% gap of recent years will remain until capital raising is complete. Moreover, such money growth rates should support robust economic activity (7-8% real growth) without leading to higher inflation.

THAILAND: COMMERCIAL BANK AND FINANCE COMPANY BALANCE SHEET ANALYSIS

22/07/93







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REGIONAL SURVEY CORE INFLATION, TRADEABLE GOODS INFLATION AND PEGGED CURRENCIES

Introduction

In a world environment of slow growth, low inflation and an imploding ERM fixed exchange rate mechanisms, Asia stands out as an exception. The economies of the region for the most part offer premium growth rates but often accompanied by relatively high and more volatile rates of inflation. Moreover, Asia's fixed exchange rate endeavours have met with considerably more success in recent years than similar attempts elsewhere. This article is divided into two sections. Section 1 examines the nature of inflation baskets in Asia and tries to identify some less volatile measures of core inflation. Section 2 looks at the behaviour of tradeable goods inflation in the region and pays special attention to those economies that keep their exchange rate in line with another currency. In addition reference is made to the behaviour of tradeable goods inflation under fixed exchange rate regimes outside of Asia -- specifically in Spain and Mexico.

Inflation Baskets in Asia

What is the "true" rate of inflation in the economies of east Asia? The answer depends on who you talk to -- the farmer, the factory worker and the mobile phone-carrying young professional will all give very different answers. The inescapable conclusion is that no single basket of prices can ever capture the diverse range of inflationary trends in different sectors of an economy as a whole. On one level, this is as true in mature economies such as the US and Japan, as it is in the developing world. For example, price cutting currently seems to be more prevalent in both the US and Japan than the CPI numbers suggest. However, the measurement of inflation in developing economies is further complicated by a faster pace of structural change and price deregulation.

In general, inflation baskets in Asia continue to be heavily weighted towards food prices and the prices of other basic commodities. This is a reflection of their roots (in the not so distant past) as primarily agrarian societies, and tends to understate the shift from the farm to the factory and the concomitant rise in real incomes which results in a falling proportion of expenditure on staples. While the Thai CPI may well reflect the spending patterns of say, a northern rice farmer, its relevance for an office worker in Bangkok is less clear. Indeed, a Bangkok citizen (or his counterpart in Kuala Lumpur, Taipei, Jakarta etc.) will likely quote a considerably higher inflation rate.

It can be argued that an understated inflation rate is not a problem if the degree of understatement is consistent. Certainly it makes sense to focus on turning points rather than absolute levels. However, the downward bias in reported inflation does not appear to be particularly consistent because 1) the price of staples (in the absence of price controls) is inherently volatile, and 2) structural economic change continues apace. In the absence of reported (as opposed to anecdotal) data on the local prices of services, consumer goods and other items which comprise the inflation basket of the up-and-coming Asian urban dweller, it is difficult to address this second point. However, some attempt can be made to smooth the reported numbers and to provide an estimate of core price rises.

Table 1 below, lists the weightings given to food and (where they are greater than 2%) fuel in the CPIs of the region. The weights for some countries shift slightly on a month-to-month basis, so those displayed are the latest available. As can be seen, food is assigned an average weight of 38.0% across the region, peaking at 44.5% in Taiwan. This average is over twice the weighting assigned to food in the US CPI. It is difficult to believe, however, that the Taiwanese or the Japanese spend in excess of 40% of their disposable income on food.

TABLE 1
ASIAN CPI WEIGHTINGS

	FOOD	FUEL
USA	17.4%	7.3%
JAPAN	41.2%	3.1%
TAIWAN	44.6%	
KOREA	32.5%	2.6%
HONG KONG	35.1%	2.5%
SINGAPORE	40.0%	
MALAYSIA	33.7%	
THAILAND	43.7%	
INDONESIA	38.0%	
<u>PHILIPPINES</u>	<u>32.9%</u>	
ASIAN AVERAGE	38.0%	

Charts 1-9 plot the CPI and the WPI against a rough measure of core inflation (CPI minus food and fuel where applicable) for the countries listed above. An initial reaction is that core inflation differs little from headline inflation although in general it is less volatile on a month-to-month basis. The most notable example of such volatility is Taiwan (Chart 3) where it sometimes appears that inflation is always and everywhere a meteorological phenomenon. Typhoons periodically send the price of fresh produce rocketing up and distort the headline numbers. Indeed the central bank raised interest rates in May 1992 in response to a jump in food prices, only to lower them a few months later. Nevertheless, the longer term direction and level of core inflation tends to differ little from its headline counterpart.

CHART 1
JAPAN: INFLATION

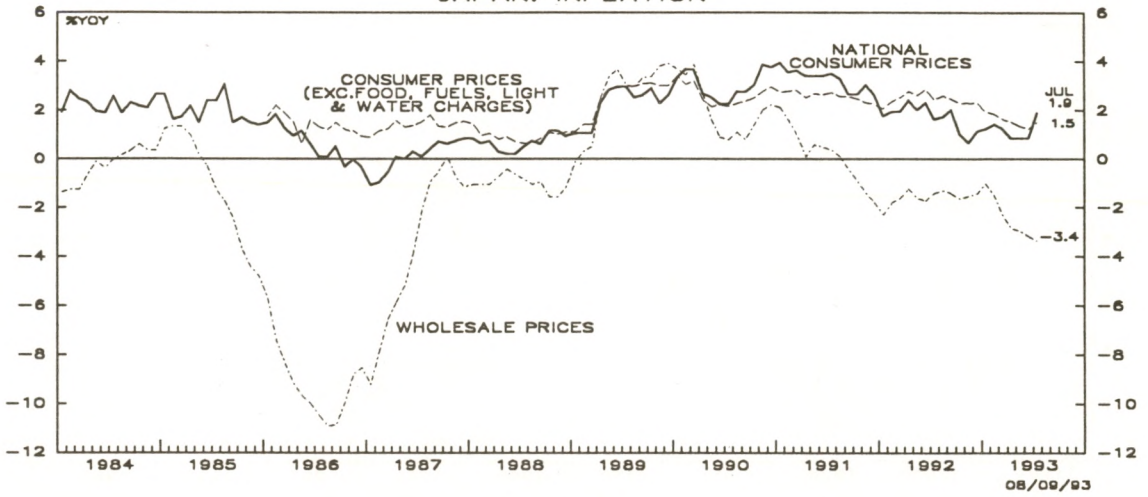


CHART 2
S. KOREA: INFLATION

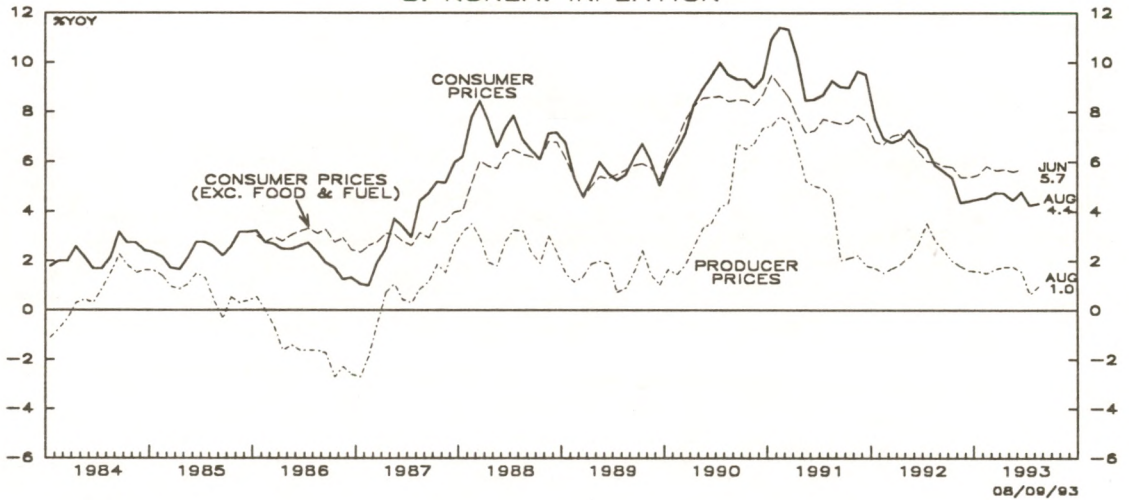


CHART 3
TAIWAN: INFLATION

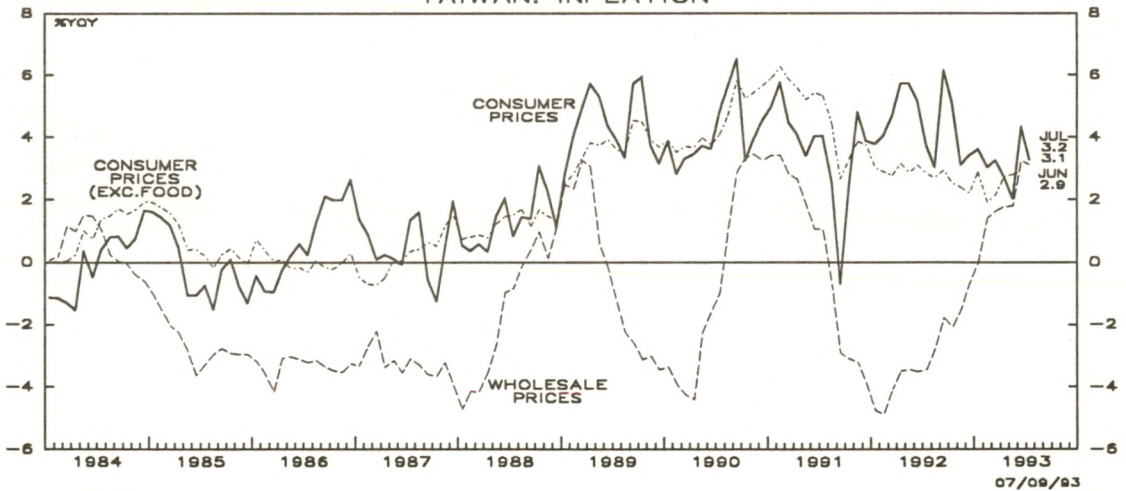


CHART 4
HONG KONG: INFLATION

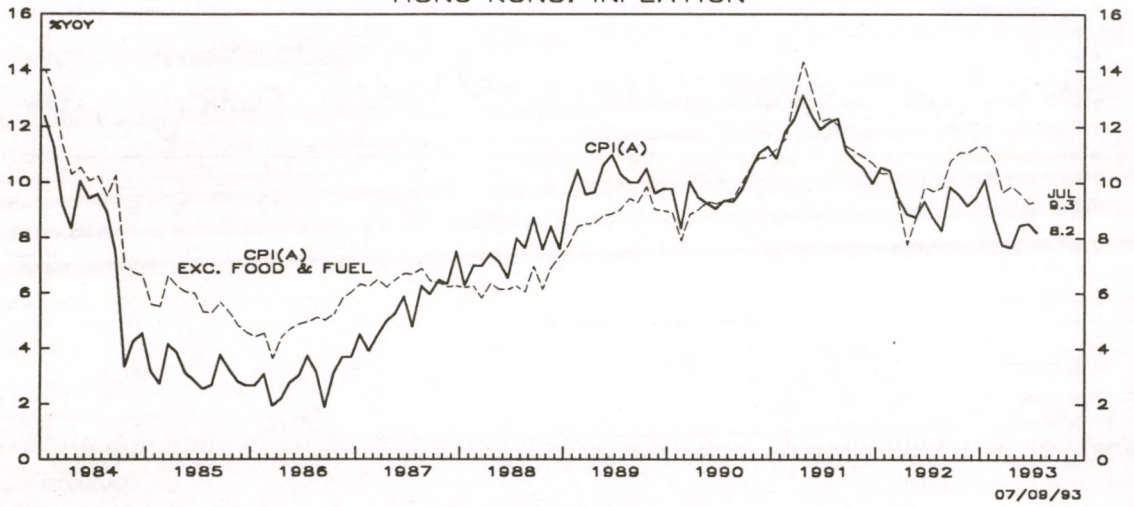


CHART 5
SINGAPORE: INFLATION

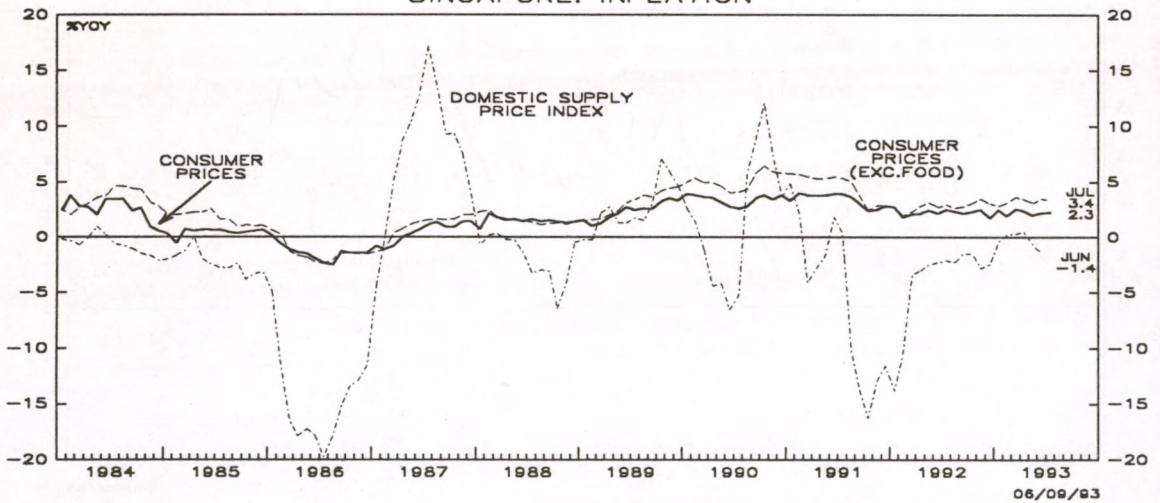


CHART 6
MALAYSIA: INFLATION

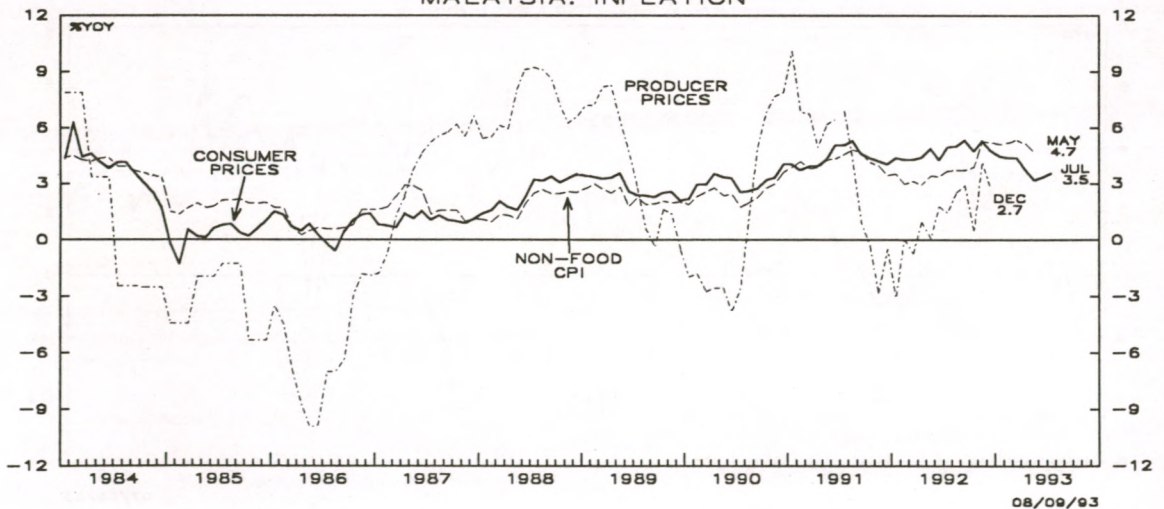


CHART 7
THAILAND: INFLATION

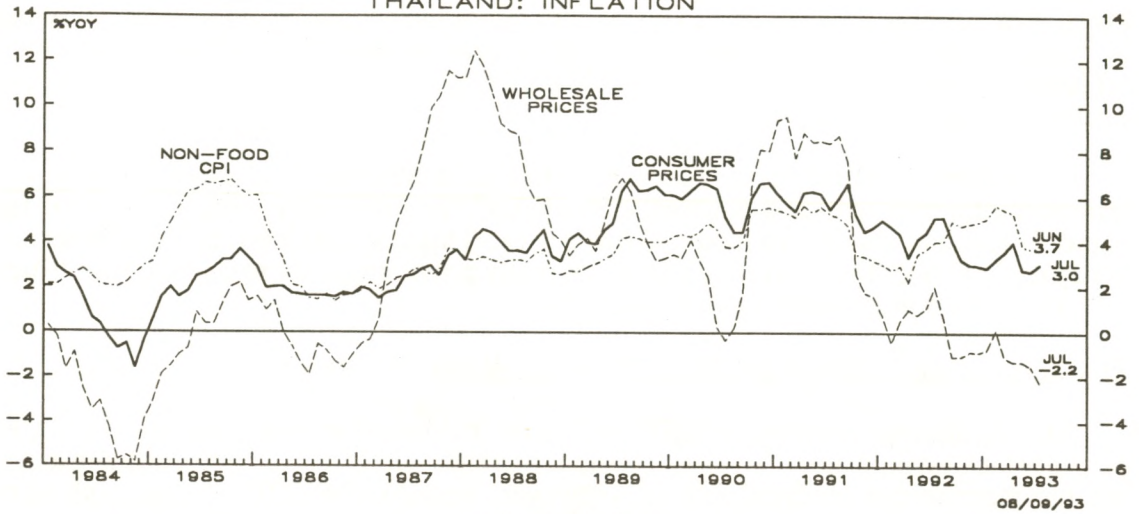


CHART 8
INDONESIA: INFLATION

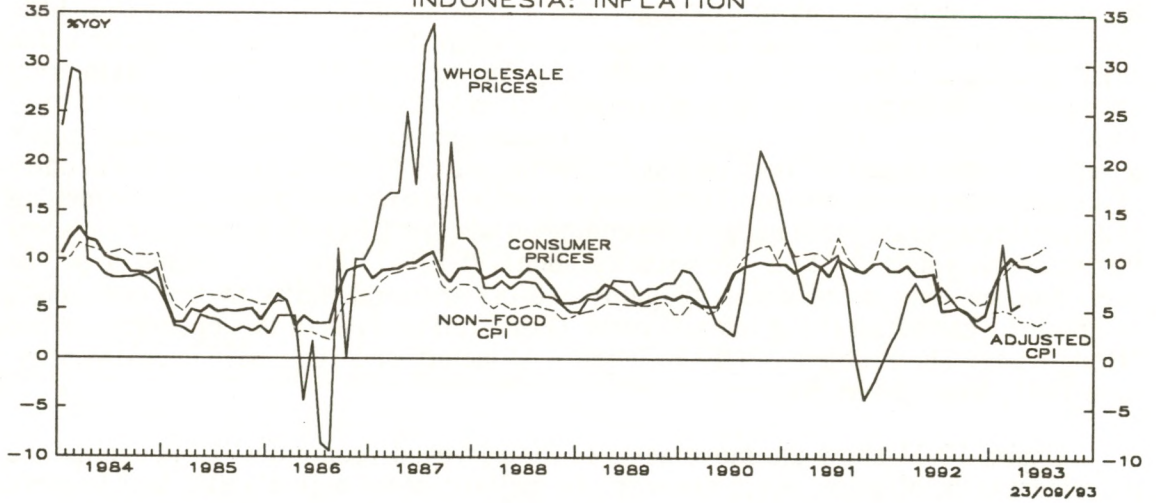
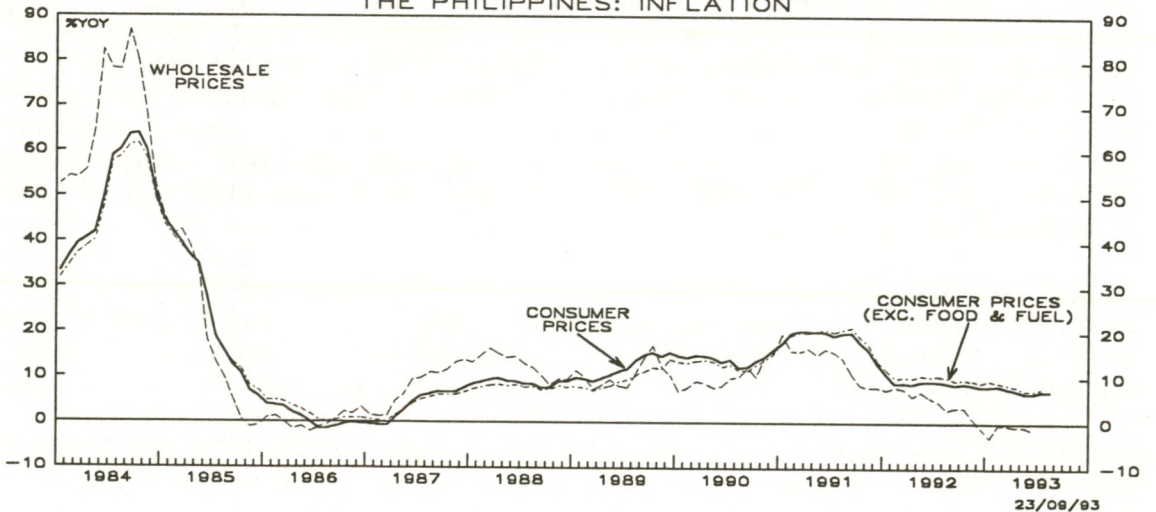


CHART 9
THE PHILIPPINES: INFLATION



The other major distortion apparent occurs in the case of price deregulations and tax hikes. For example inflation spiked up in Indonesia at the beginning of this year following increases in oil, electricity, transport, telecommunications and cement charges. Such one-off jumps should be stripped-out, if possible (Chart 8), and are to be welcomed if they are a reflection of economic liberalisation.

The somewhat limited conclusion must be that in the absence of re-weightings more reflective of actual spending patterns, one can do little more than adjusting the CPI for one-off items and changes in food and fuel prices. This may produce less volatile series, but apart from over the short run, it does not really provide a better measure of the "true" rate of inflation in the economies of east Asia.

Tradeable Goods Inflation and Fixed Exchange Rates

In the absence of a regular GDP deflator -- published at best quarterly -- the CPI provides the best indicator of overall inflationary trends within an economy, notwithstanding the reservations outlined above. However, because the CPI includes both non-tradeable and tradeable goods, it may not be the best measure of external competitiveness. In an environment of floating exchange rates and slow productivity growth (i.e. little structural change) there is often little to choose between the CPI and an export price index or EPI (see the article on Sri Lanka in AMM July-August 1993, Vol. 17 No. 4), as internal price rises are often passed straight on to export prices leading to a depreciation of the local currency. However, under a regime of fixed or managed exchange rates, tradeable goods inflation is constrained to more or less follow the prices of traded goods in the country of the exchange rate shadowed. This law of one price may result in a squeeze or widening of domestic corporate profit margins depending on whether CPI inflation exceeds or is less than tradeable goods inflation. Nevertheless such CPI-EPI differentials can and do persist over time as long as productivity gains and/or structural shifts in the economy's composition can offset rising internal costs. (For a full analysis of this phenomenon see "Hong Kong: The Problem of CPI Inflation -- Monetary or Structural?" in AMM May-June 1991, Vol. 15 No. 3).

Charts 10-14 show the movements of the surveyed economies' EPIs against the movement in the oil price. As can be seen, the majority of the region's EPIs tend to move closely with the price of oil although currency shifts can mask some of the effect. Japan's EPI in US dollar terms demonstrates this divergence (Chart 10). The exceptions are, perhaps unsurprisingly, Hong Kong (Chart 12) and Thailand (Chart 13) -- economies that have pegged themselves (formally or informally) to the US dollar since 1983 and 1987 respectively. The law of one price has constrained their export prices to follow those in the US which in turn have been less volatile than elsewhere due to America's relatively low reliance on imported oil. The volatility of EPI changes since 1987 is only 1.8% in Hong Kong and 5.8% in Thailand (3.3% since 1989), compared to an average of 7.5% in the rest of the region.

Charts 15 and 16 demonstrate how export prices in Hong Kong and Thailand adjusted to the level of their US counterpart reasonably swiftly following the pegging of their currencies. Volatility of export prices subsequently diminished as exporters learned to adjust their prices to follow those of US tradeables in order to remain competitive at the given exchange rate. Nevertheless, CPI inflation in both countries has continued to outstrip EPI inflation over the period of the peg. Higher productivity and structural economic change -- Hong Kong manufacturing industry relocating to southern China, Thai migration from the farm to the factory -- have accommodated this divergence.

CHART 10
GROWTH IN EXPORT PRICE AND THE OIL PRICE

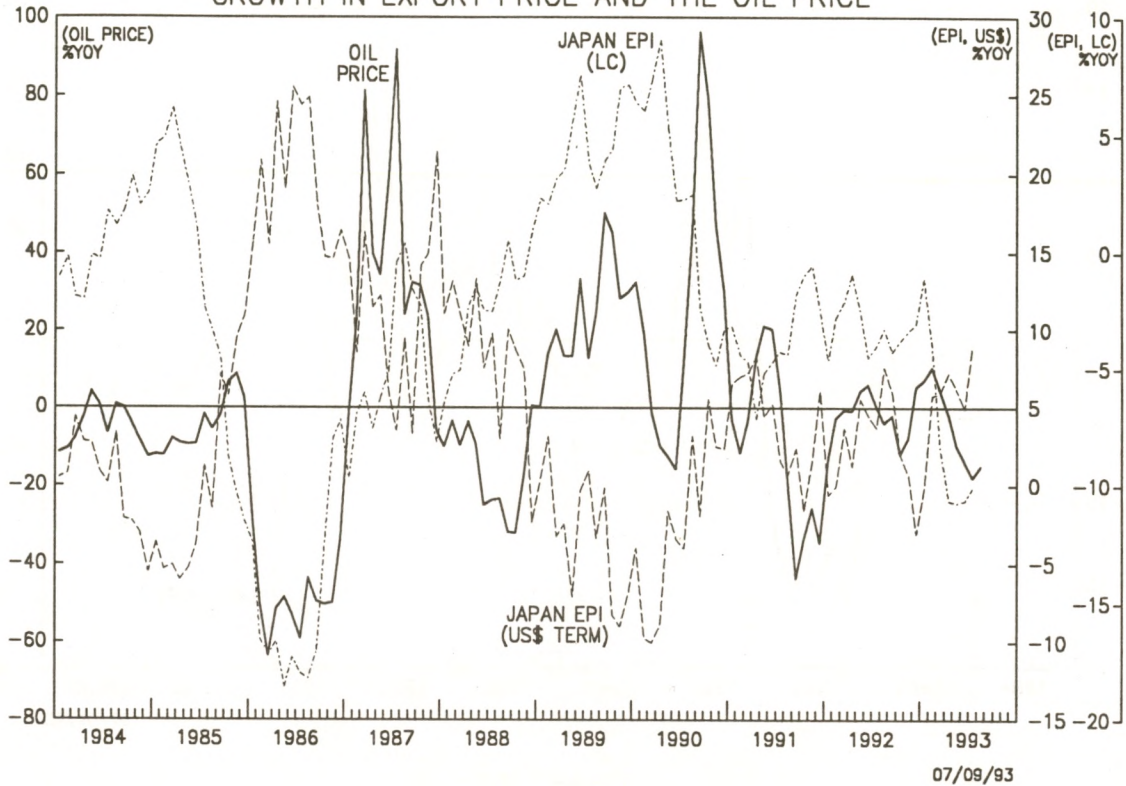


CHART 11
GROWTH IN EXPORT PRICES AND THE OIL PRICE

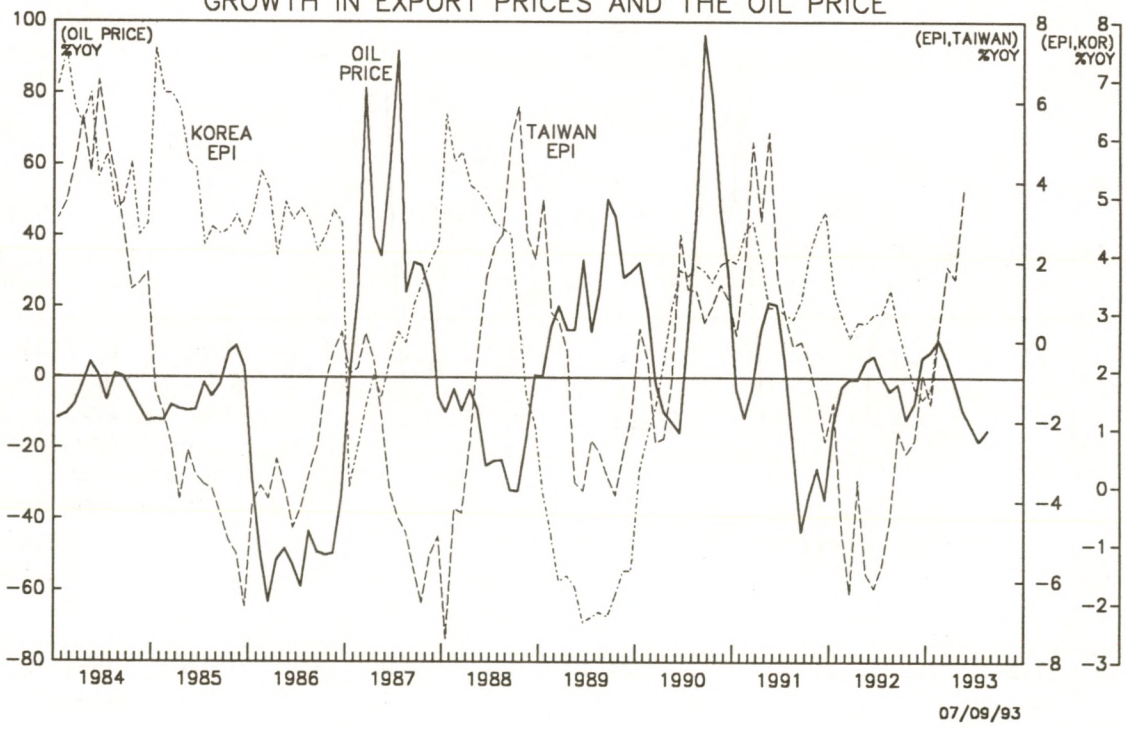


CHART 12
GROWTH IN EXPORT PRICES AND THE OIL PRICE

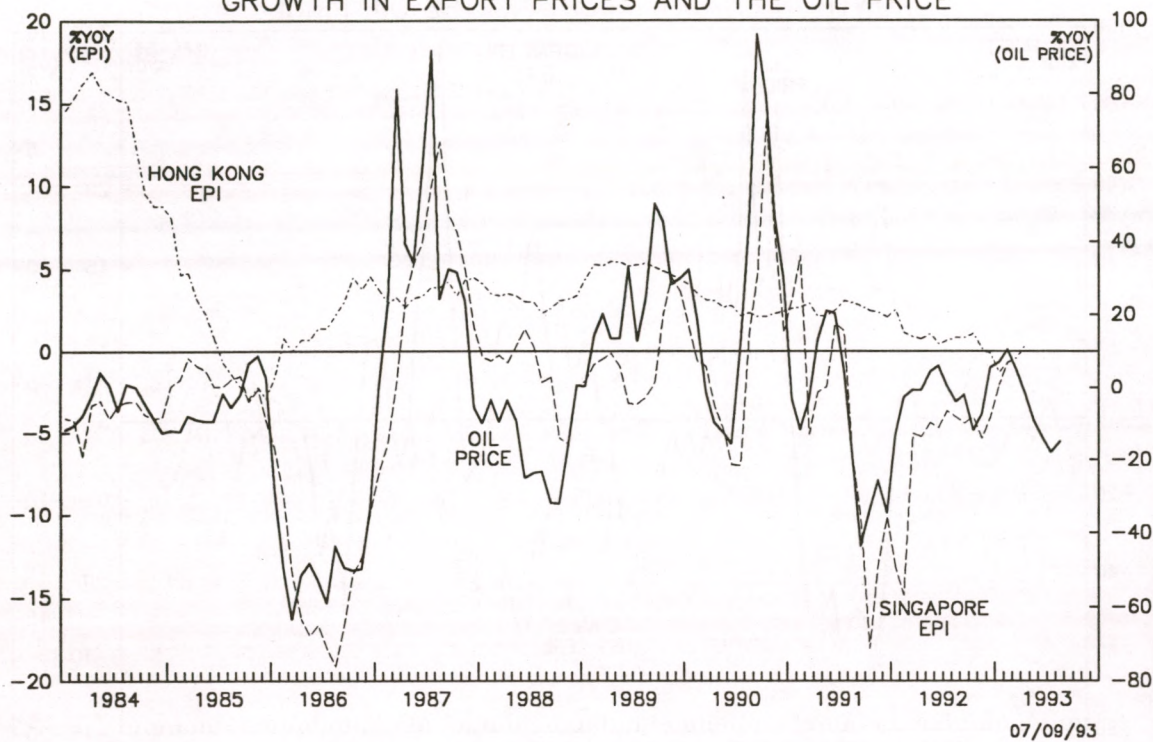


CHART 13
GROWTH IN EXPORT PRICES AND THE OIL PRICE

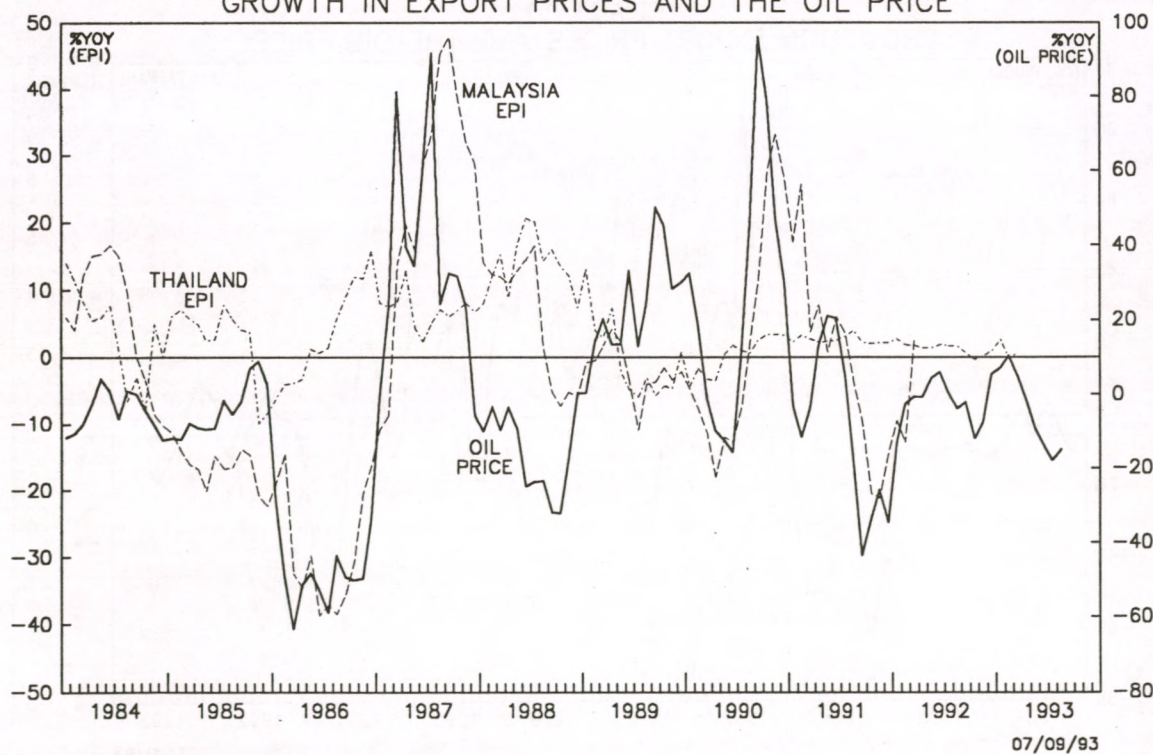


CHART 14
GROWTH IN EXPORT PRICES AND THE OIL PRICE

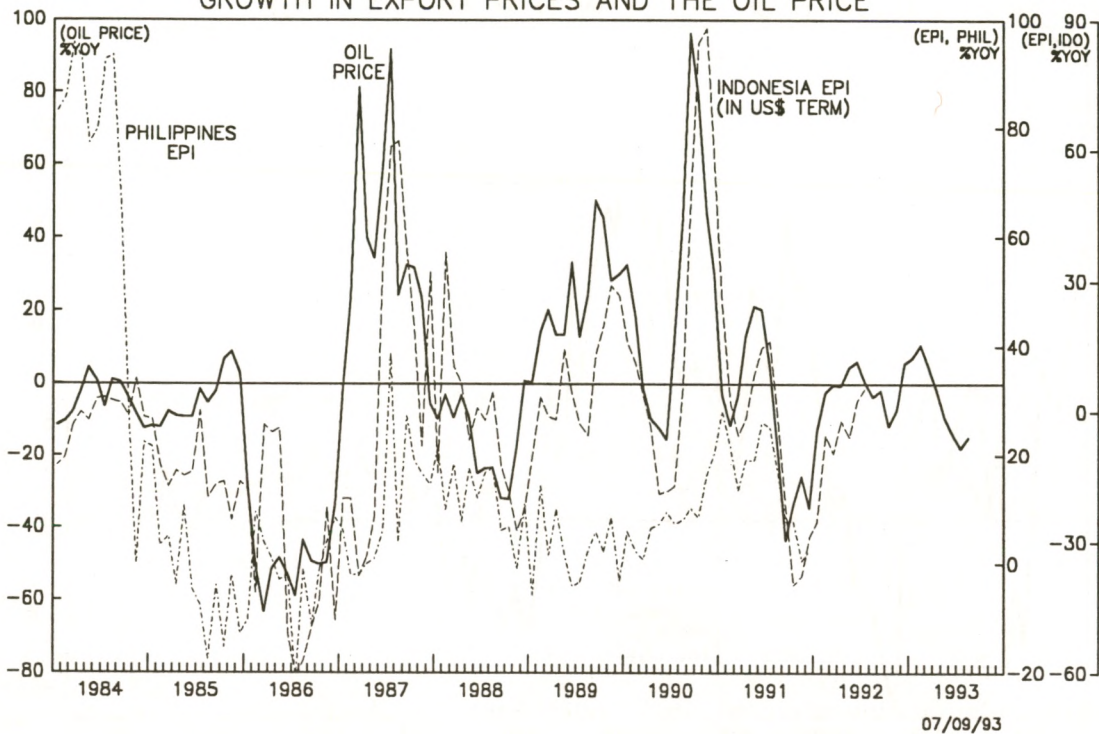


CHART 15
GROWTH OF PRICES IN HONG KONG AND U.S.

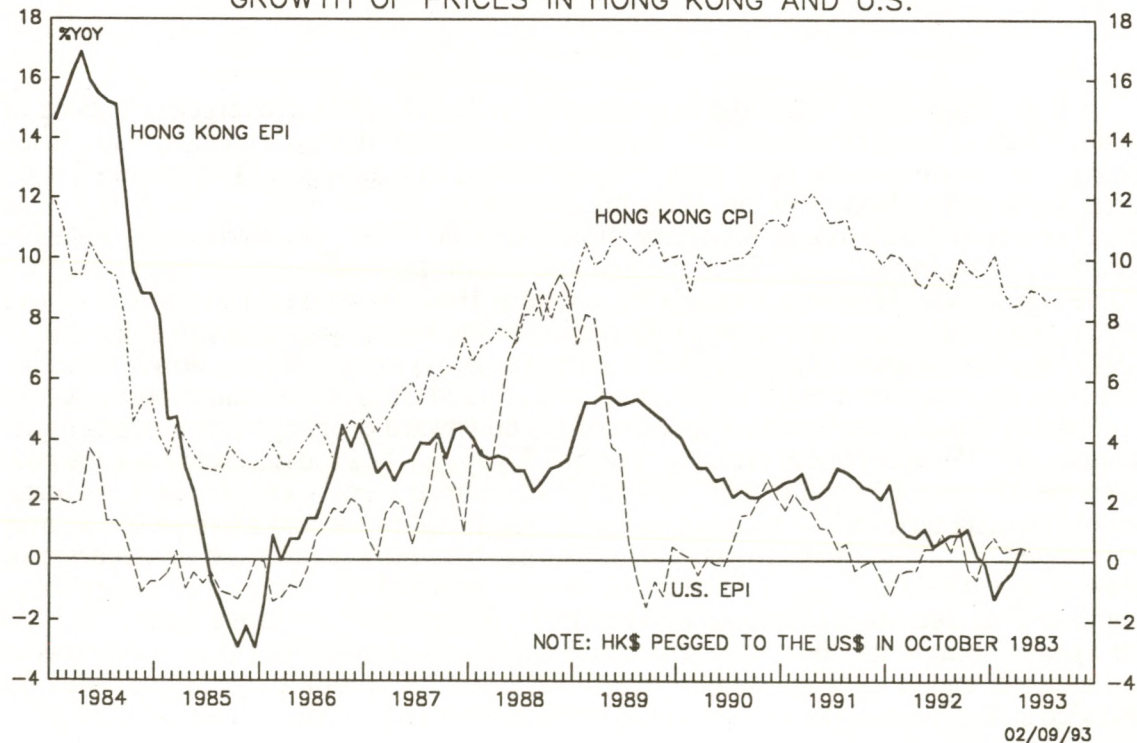
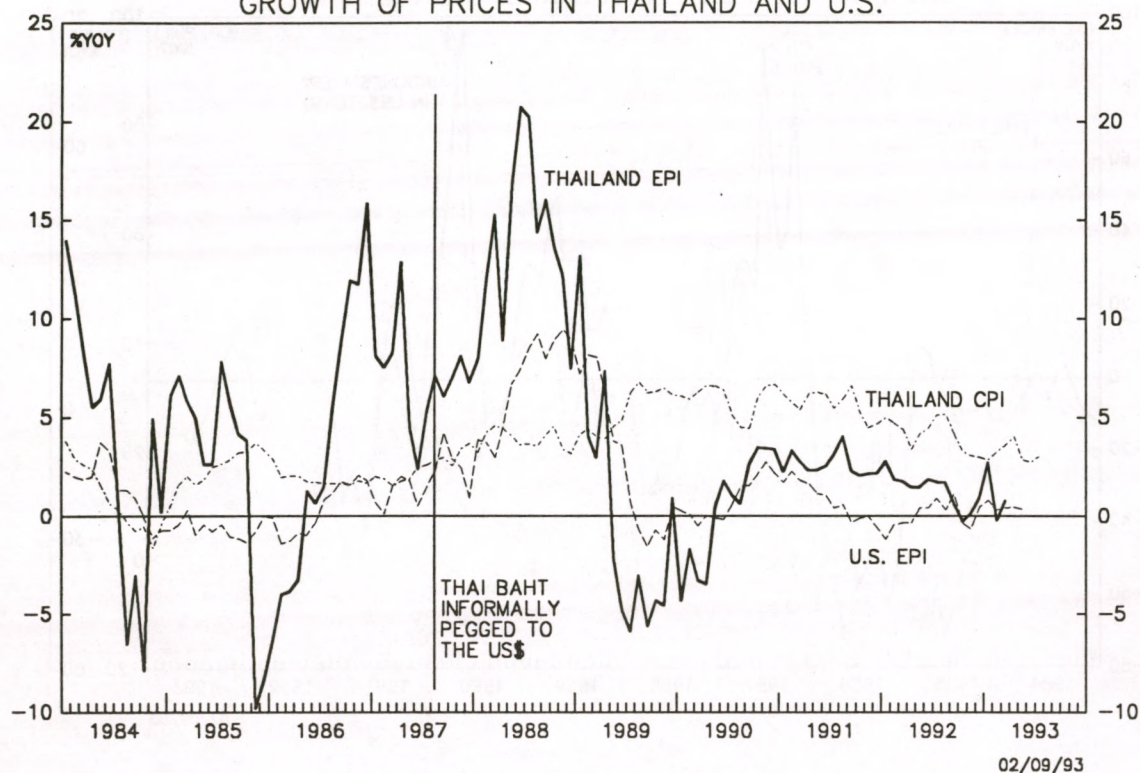


CHART 16
GROWTH OF PRICES IN THAILAND AND U.S.



It is illuminating to test the hypothesis of tradeable goods convergence outside of Asia. Charts 17 and 18 illustrate the fortunes of Spain and Mexico who have also chosen to peg their currencies in recent years. Spain started to shadow the Deutschmark soon after joining the (then) EEC in 1986, in preparation for entering the Exchange Rate Mechanism of the European Monetary System in June 1989. As can be seen tradeable goods inflation in Spain rapidly converged to German rates although CPI rates remained somewhat higher. However, towards the middle of 1991, the Spanish EPI started to move away from its German counterpart culminating in the Peseta's devaluation at the end of 1992. Mexico's case is slightly different since it employs a crawling peg slowly adjusting the Peso down against the US dollar. In theory, this constrains Mexican export prices to follow US export prices plus the amount of the downward exchange rate movement per annum. (If US export prices are increasing at 3% yoy and the Peso has weakened 5% yoy, then the Mexican EPI can increase 8% to leave competitiveness unchanged.) Unfortunately the data series on Mexican export prices is limited to one and a half years but over this period the premise seems to have held. The gap between Mexican and US export price rises widened in late 1992 but since then it has reversed and on average, prices have been much in line. Mexico's EPI could well be more volatile than either Hong Kong, Thailand or Spain's because like Indonesia which also employs a crawling peg (Chart 14), it is an oil exporter and is therefore subject to a world price. A non-oil export price index for Mexico and Indonesia, if available, could be expected to be less volatile and to follow more closely the law of one price.

CHART 17
GROWTH OF PRICES IN SPAIN AND
GERMANY AND THE PESETA/DM EXCHANGE RATE

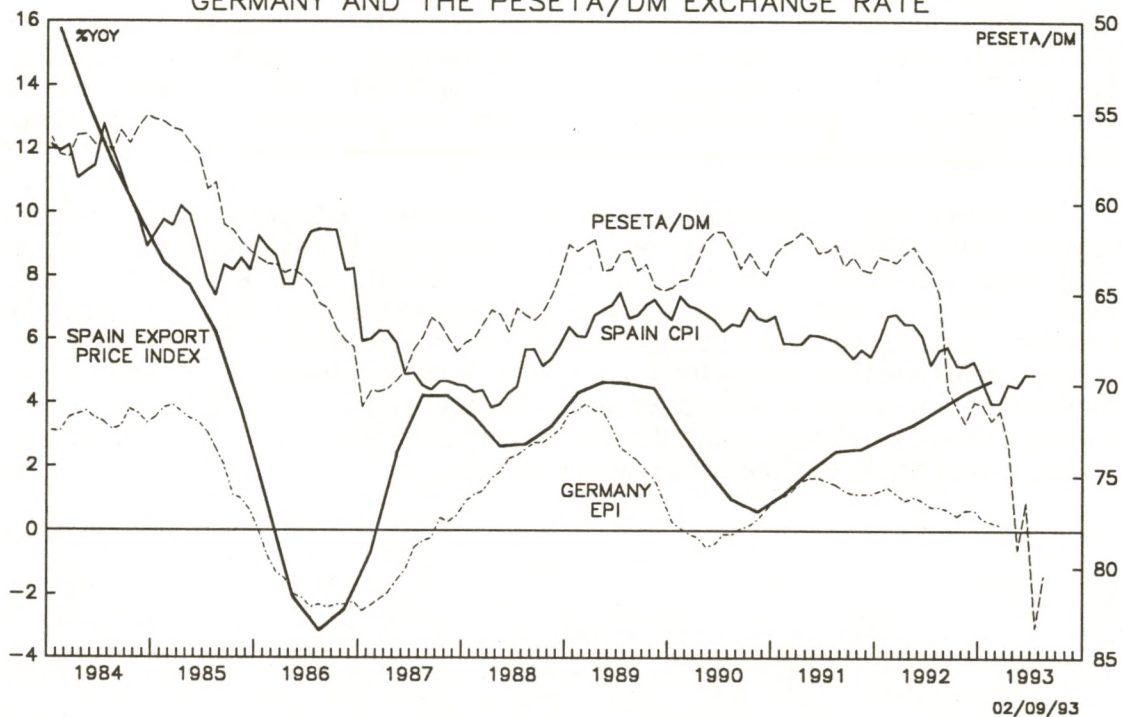
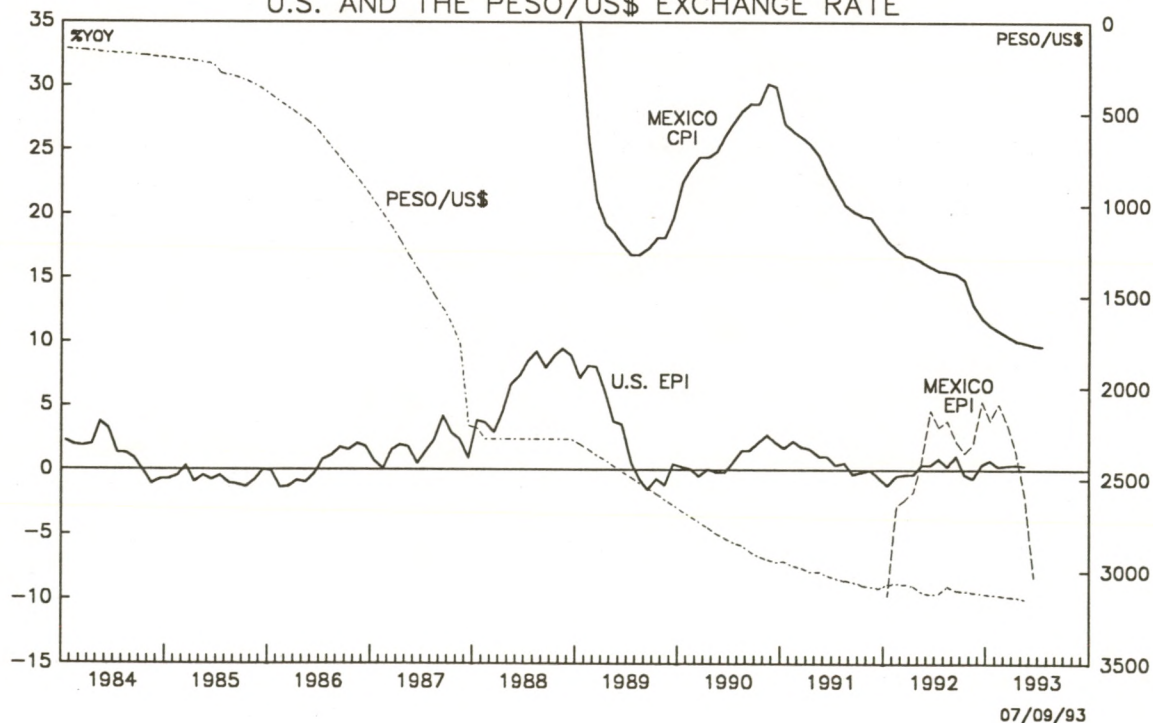


CHART 18
GROWTH OF PRICES IN MEXICO AND
U.S. AND THE PESO/US\$ EXCHANGE RATE



CONCLUSION: Asian CPI inflation baskets remain reflective of agrarian economies and bear little relevance to actual urban spending patterns. The dominance of food in the CPIs of the region also adds to the volatility of the indices. Nevertheless, in the absence of better survey data of service prices and appropriate re-weightings, one can do little more than adjust the CPI for one-off items and changes in food and fuel prices. This may produce less volatile series, but apart from over the very short run, it does not provide any better measure of the "true" rate of inflation in the economies of east Asia.

Patterns of tradeable goods inflation show that the law of one price constrains export prices in countries that operate under a regime of fixed or managed exchange rates to follow export prices in the country to which the currency is linked. Hong Kong and Thailand have tended to have much lower and less volatile EPIs since linking their currencies to the US dollar. Indonesia could also be expected to follow this trend but the absence of a non-oil EPI prevents one from testing the hypothesis. The pattern also holds in Mexico (over a short period -- it cannot be fully tested due to data limitations) and in Spain. However, the devaluation of the Peseta against the Deutschemark demonstrates clearly the perils of allowing export prices to violate the law of one price.

REGIONAL SURVEY

REAL EFFECTIVE EXCHANGE RATES REVISITED

In a previous AMM article ("Asian Currency Valuations", AMM July-August 1992, Vol. 16 No. 4), we presented our updated and preferred Real Effective Exchange Rates (REERs) for the region. The conclusion was that REERs based on wholesale prices (export prices for Japan and Hong Kong) were the superior measure, and that the region as a whole had remained competitive over time, especially ASEAN.

This article refines our measures further and employs moving trade weights (twelve month moving averages to smooth the data) as opposed to trade weights taken at a single date. (No moving weight REER is calculated for Indonesia or the Philippines due to trade data limitations.) Moving weights allow our REERs to capture shifts in trading patterns over time as well as shifts in relative prices. An appendix outlines the statistical justification for our calculations.

Once again we have limited ourselves to the eight major trading partners in terms of value of exports in 1992. These top eight partners account for around two-thirds of total exports in general (Table 1). There is a minor flaw in this methodology as the eight principal trading partners may not be the same eight going back over time. Nevertheless, we are interested in the relative trading shifts over time and those countries, which are now excluded, but which would have been included in earlier years, normally have a small overall weighting. At least six countries remained in the top eight over the whole time period and their cumulative share in total exports remained fairly stable. However, shifts in their relative weights were more marked and this is reflected in divergences between our "old" and "new" REER measures.

TABLE 1
EXPORT SHARES OF ASIAN ECONOMIES

	Japan	H.K.	Taiwan	Korea	Sing.	Mal.	Thai.
Top 8 Partners in 1992 (ex China) as a % of 1992 Total	65.8%	55.9%	73.3%	61.9%	66.6%	72.8%	68.1%
Partners in 1992 Top 8 and 1970 Top 8	6	7	7	6	7	6	7
Top 8 Partners 1992 and 1970 as a % of 1970 Total	58.7%	55.9%	69.9%	54.7%	66.4%	69.1%	68.1%
Top 8 Partners 1970 as a % of 1970 Total	66.1%	58.0%	70.7%	56.6%	72.6%	71.3%	72.0%

Notes: Hong Kong, domestic export shares

Hong Kong and Thailand, previous base date for weights: 1972

Korea and Singapore, previous base date for weights: 1975

Another problem is the exclusion of China from our calculations due to a lack of trade weights and inflation data going back over time. Table 2 shows that the inclusion of indirect exports via Hong Kong raises China to the third or fourth most important export destination for the north Asian economies. Hong Kong's exposure is even greater on the face of it, but stripping out outward processing trade destined for a third country lessens its importance somewhat (and adds to the weightings of other countries as a result although accurate calculations are not possible). As trade with China throughout the region grows over time, and as the Chinese currency is made more freely convertible, the exclusion of the mainland from our calculations will become progressively more significant. For the moment, however, we choose to ignore it.

TABLE 2
1992 EXPORTS TO CHINA AS A % OF TOTAL EXPORTS

	Japan	H.K.*	Taiwan	Korea	Sing.	Mal.	Thai.
Direct	3.5%	6.5%	-	3.5%	1.8%	1.9%	1.2%
Via Hong Kong	2.1%	-	8.7%	2.4%	1.3%	-	-
Total	5.6%	6.5%	8.7%	5.9%	3.1%	1.9%	1.2%
Rank (Direct)	8	3	>8	6	>8	>8	>8
Rank (Total)	4	3	4	3	8	>8	>8

* Excluding outward processing trade

Charts 1-7 plot the constant and moving weight REERs for our surveyed countries. Divergences between the two measures are more marked for Japan and the NICs than for ASEAN. For Japan, Taiwan, Korea and especially Singapore, trading patterns shifted quite noticeably in the early 1980s although the major shifts appeared to come to an end by the close of the decade. Singapore, however, is significantly less competitive using this new basis. Hong Kong's REERs move virtually in tandem over the whole period but the China reservations expressed above apply most to the colony. Finally, Malaysia and Thailand have seen more recent divergences between their two REER measures (starting in the mid-1980s,) but again there have been no further major shifts in trading pattern in the last couple of years.

Charts 8 and 9 compare the moving weight REERs across countries (fixed weights for Indonesia (non-oil exports) and the Philippines). The moving weight REERs suggest little real loss in competitiveness over time. Japan, Taiwan and Korea have become more competitive over the last few years following a period of lost competitiveness in the mid to late 1980s. Hong Kong and Singapore by contrast have tended to have more stable REERs and their levels of competitiveness are more in line with ASEAN. The exception here is the Philippines which remains the most uncompetitive economy in Asia despite recent Peso weakness. Although the moving and fixed weight REERs are currently much in line, divergences between them in the past suggest that the new calculation method does add value, and will be more appropriate should regional trading patterns start to shift rapidly once more.

CHART 1:
REAL EFFECTIVE EXCHANGE RATES FOR JAPAN

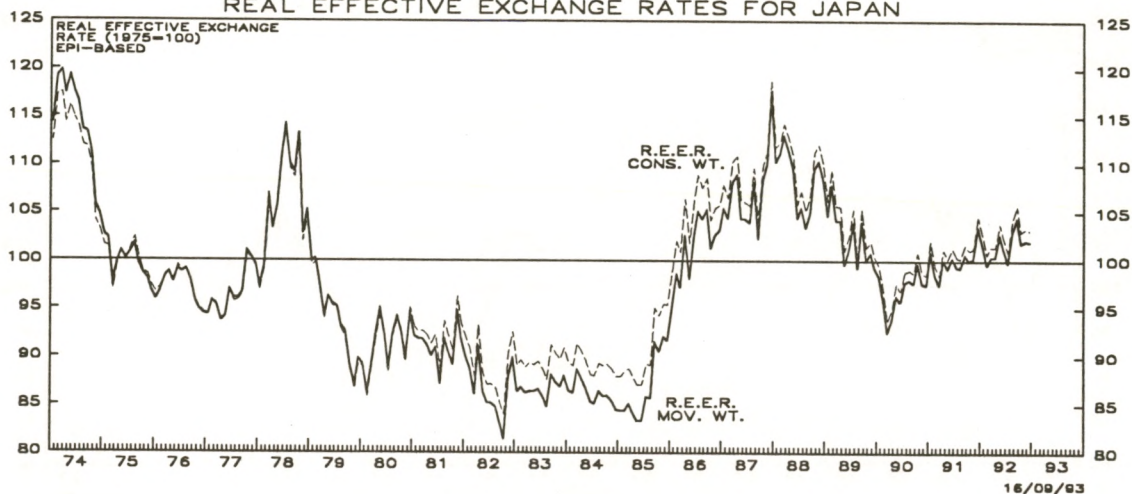


CHART 2:
REAL EFFECTIVE EXCHANGE RATES FOR HONG KONG

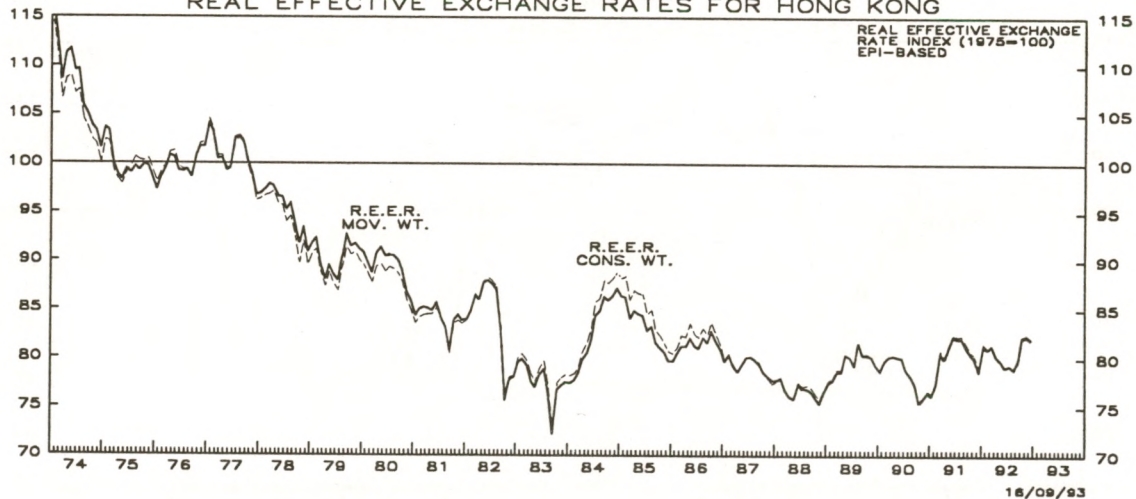


CHART 3:
REAL EFFECTIVE EXCHANGE RATES FOR TAIWAN

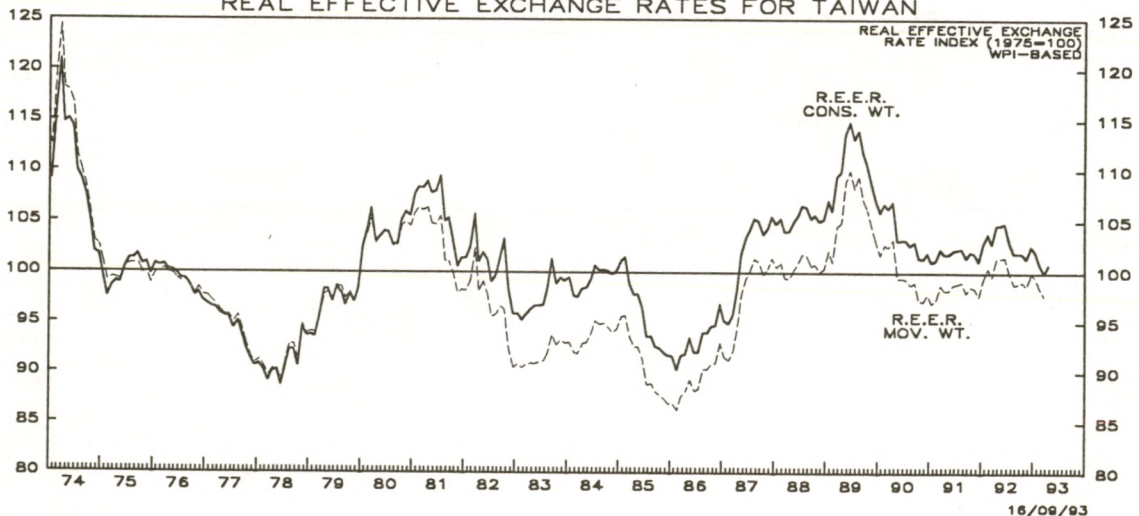


CHART 4:
REAL EFFECTIVITY EXCHANGE RATES FOR KOREA

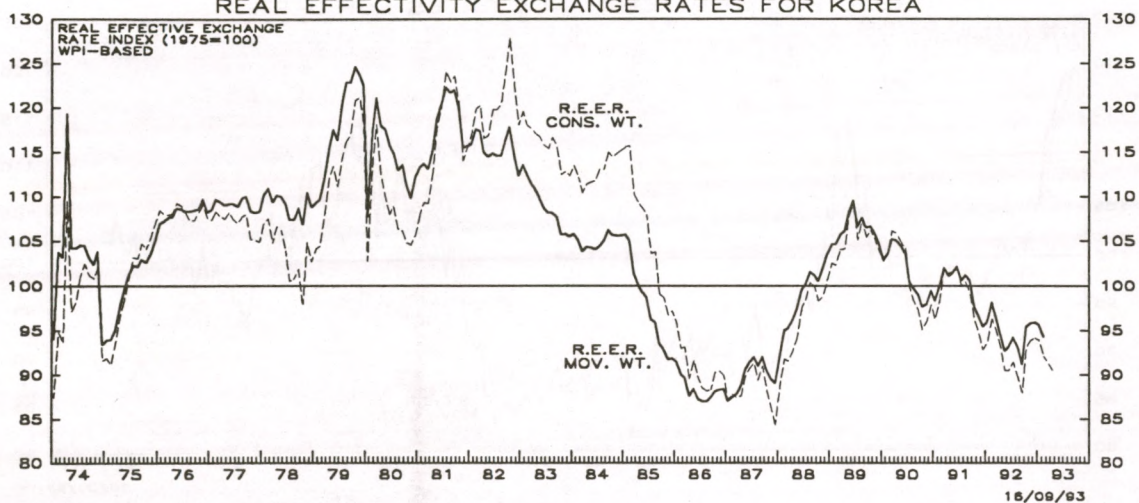


CHART5:
REAL EFFECTIVE EXCHANGE RATES FOR SINGAPORE

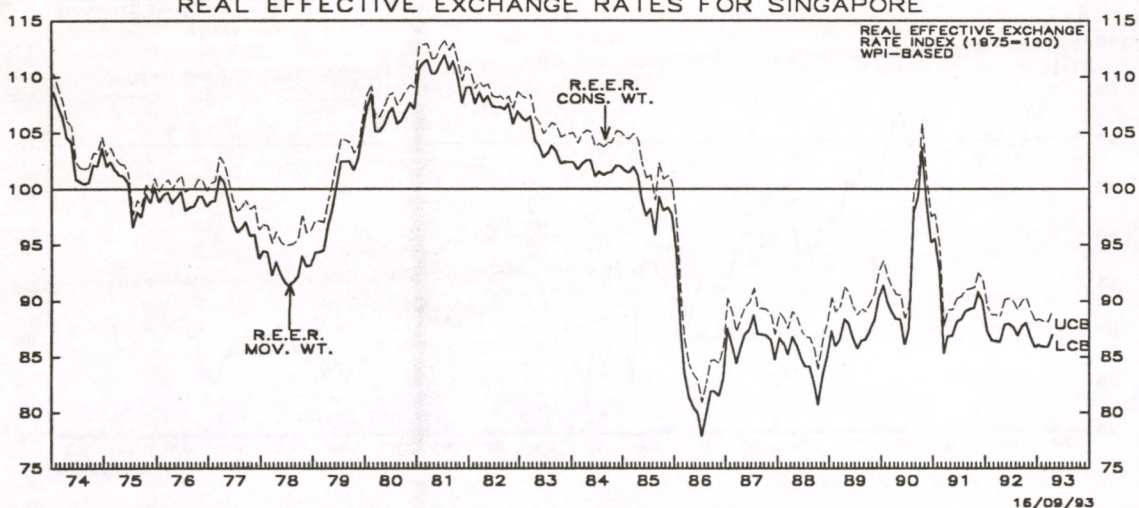


CHART 6:
REAL EFFECTIVE EXCHANGE RATES FOR MALAYSIA

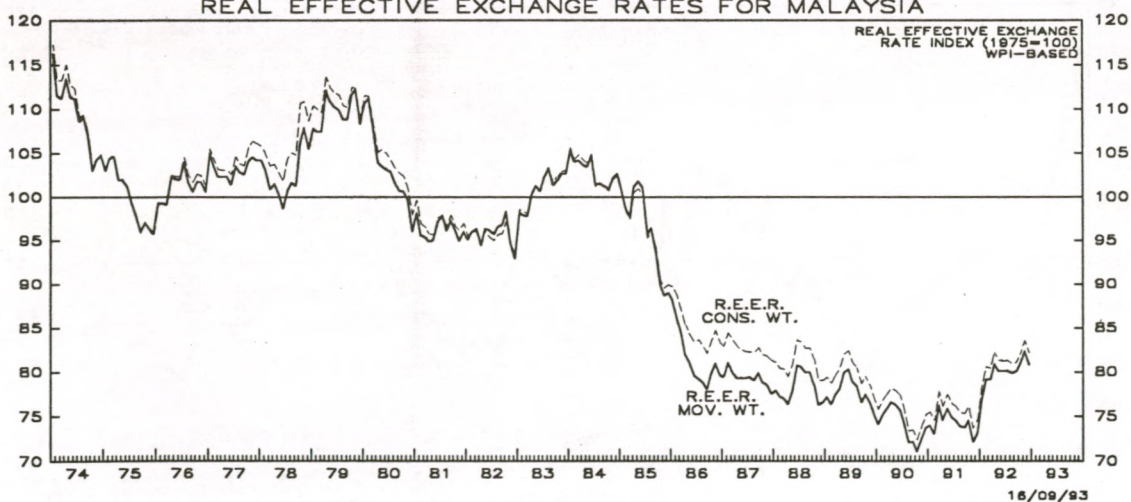


CHART 7:
REAL EFFECTIVE EXCHANGE RATES FOR THAILAND

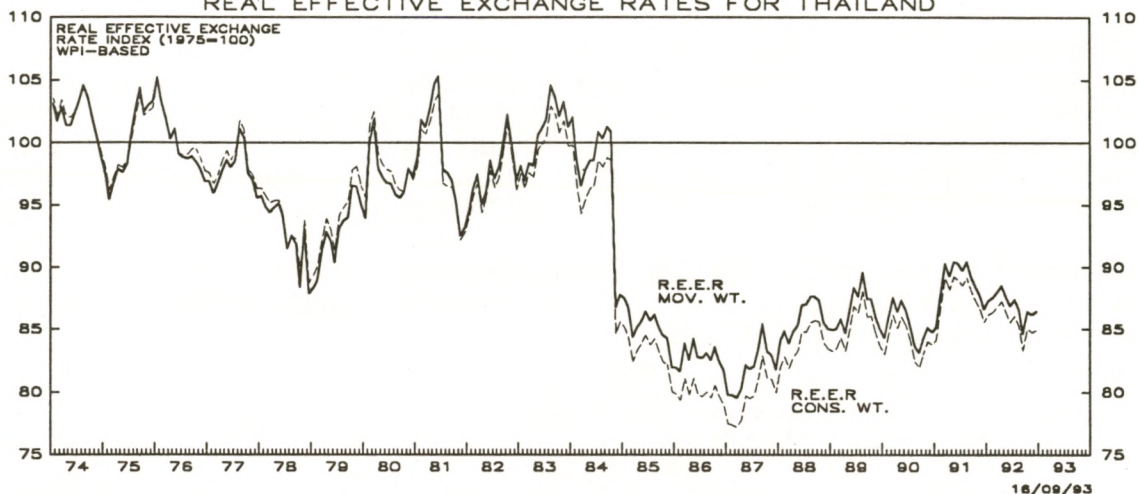


CHART 8:
R.E.E.R.S FOR TAIWAN, KOREA, HONG KONG, JAPAN AND SINGAPORE

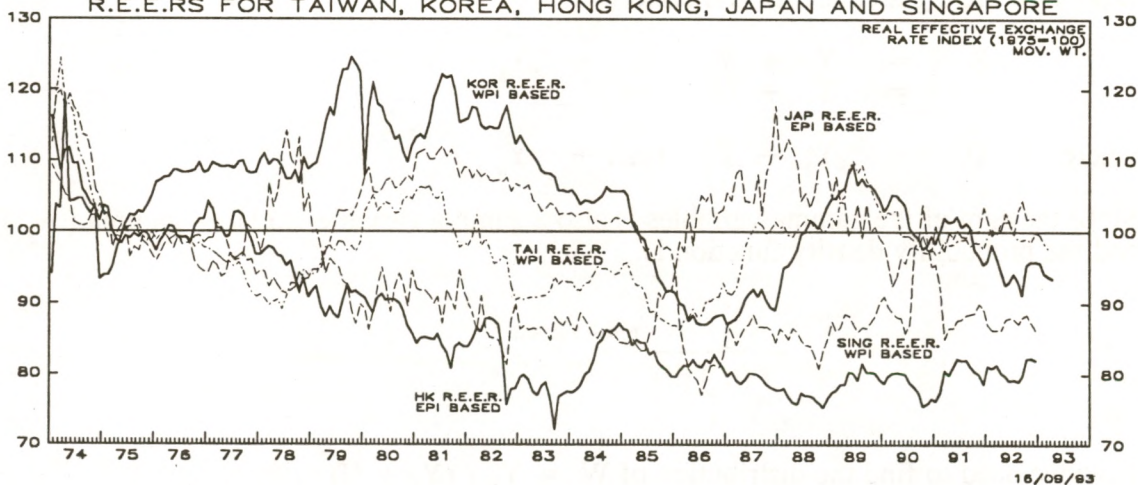
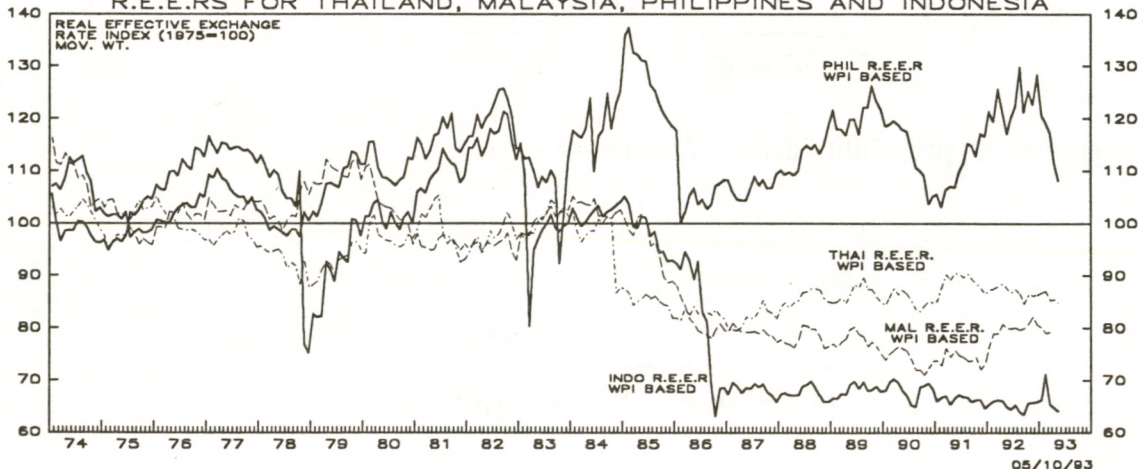


CHART 9:
R.E.E.R.S FOR THAILAND, MALAYSIA, PHILIPPINES AND INDONESIA



APPENDIX

The new method of calculating the real effective exchange rate index is based on the more realistic assumption that the trade-weights of each trading partner change over time. We can consider that the monthly exports to each trading partner are random variables in a statistical sense. We can then construct a probability distribution for the weight of each trading country since the weight is the ratio of the monthly exports to that country over the total sum of exports to all the eight principal trading countries.

We assume that the monthly exports to Country One follows a gamma distribution since exports cannot have negative value. If Y_1 is the monthly exports to Country One the probability density function of Y_1 is

$$\frac{1}{\Gamma(\alpha_1)\beta^{\alpha_1}} y_1^{\alpha_1-1} e^{-y_1/\beta}$$

where Γ is a gamma function and e^x is an exponential function. The total sum of monthly exports to the eight countries is therefore

$$S = Y_1 + Y_2 + \dots + Y_8$$

$$= Y_1 + U$$

where $U = Y_2 + Y_3 + \dots + Y_8$

Since the sum of the gamma variables is also a gamma variable, so $U \sim \text{gamma}(\alpha_2)$ and the probability density function is

$$\frac{1}{\Gamma(\alpha_2)\beta^{\alpha_2}} U^{\alpha_2-1} e^{-u/\beta}$$

Now we need to find the distribution of $W_1 = Y_1 / (Y_1 + U)$
We can construct the joint probability density function of W_1 and U :

$$g(u, w_1) = \frac{1}{\Gamma(\alpha_1)\Gamma(\alpha_2)\beta^{\alpha_1+\alpha_2}} \frac{u^{\alpha_1+\alpha_2-1} w_1^{\alpha_1-1}}{(1-w_1)^{\alpha_1+1}} e^{-u/(1-w_1)\beta} \quad 0 < w_1 < 1$$

Therefore the probability density function of W_1 is

$$g_w(w_1) = \int_0^\infty g(u, w_1) du$$

$$= \int_0^\infty \frac{1}{\Gamma(\alpha_1)\Gamma(\alpha_2)\beta^{\alpha_1+\alpha_2}} \frac{u^{\alpha_1+\alpha_2-1} w_1^{\alpha_1-1}}{(1-w_1)^{\alpha_1+1}} e^{-u/(1-w_1)\beta} du$$

CHART 10:
REAL EFFECTIVE EXCHANGE RATES FOR TAIWAN

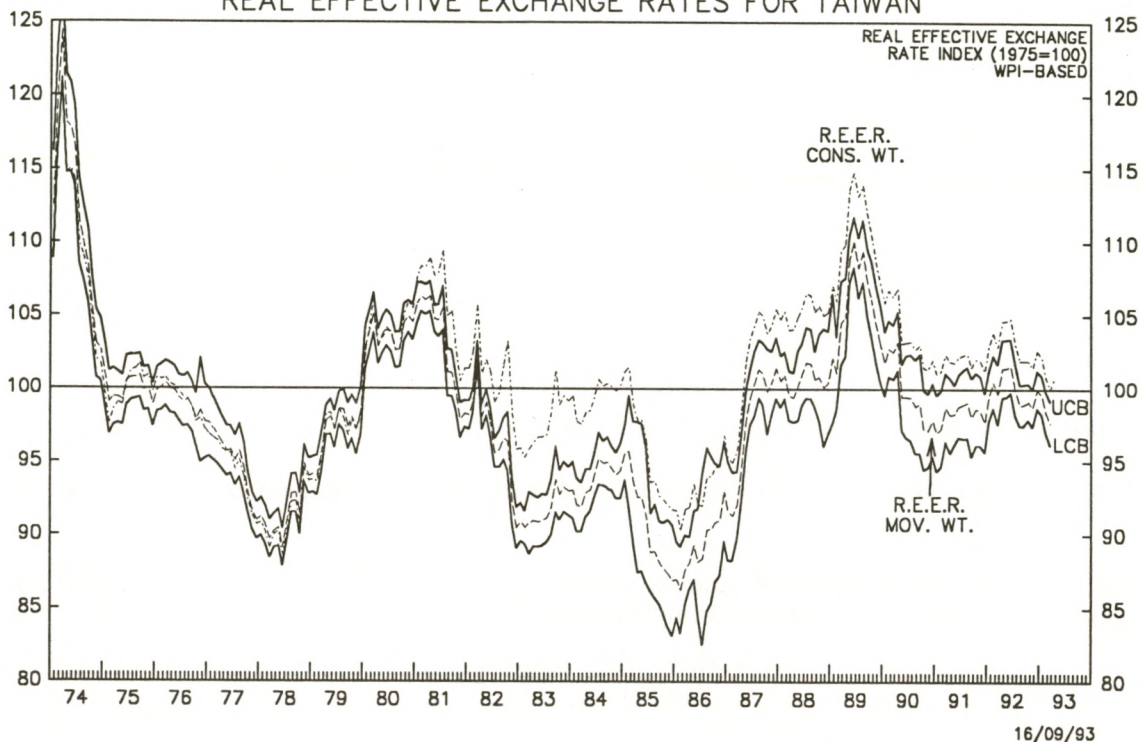
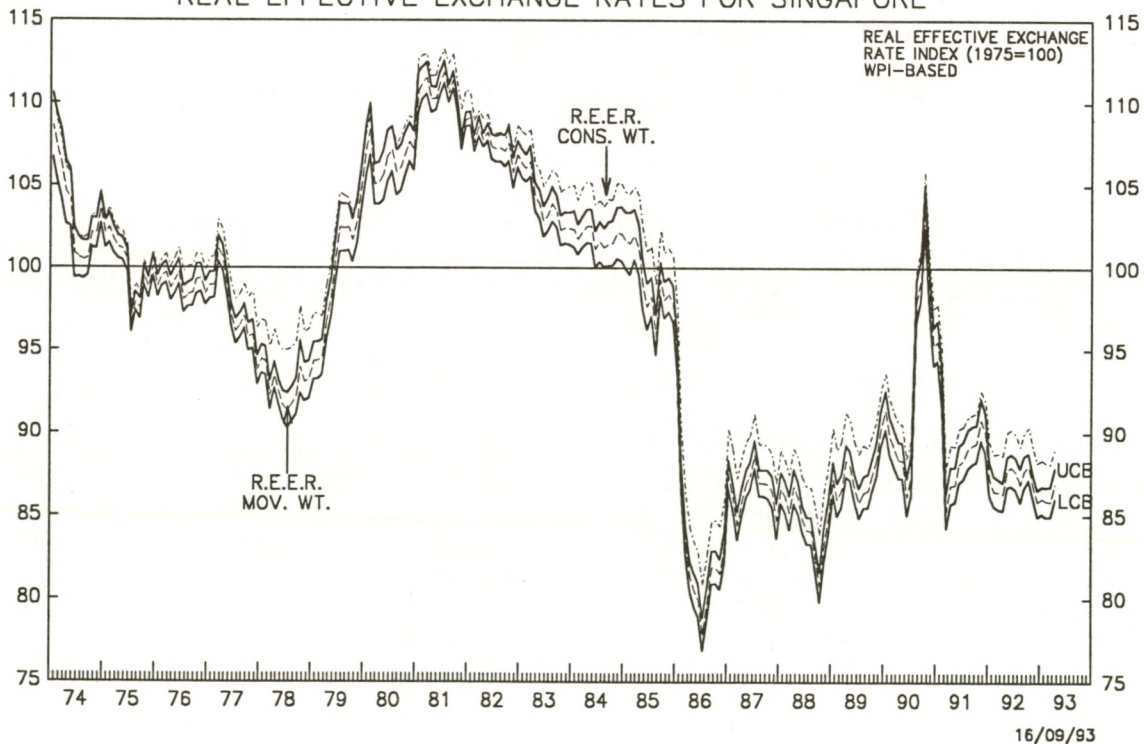


CHART 11:
REAL EFFECTIVE EXCHANGE RATES FOR SINGAPORE



$$\begin{aligned}
&= \frac{\Gamma(\alpha_1 + \alpha_2)}{\Gamma(\alpha_1)\Gamma(\alpha_2)} \frac{w_1^{\alpha_1-1}}{(1-w_1)^{1-\alpha_2}} \int_0^\infty \frac{u^{\alpha_1+\alpha_2-1}}{\Gamma(\alpha_1 + \alpha_2) \beta^{\alpha_1+\alpha_2} (1-w_1)^{\alpha_1+\alpha_2}} e^{-u/(1-w_1)\beta} du \\
&= \frac{\Gamma(\alpha_1 + \alpha_2)}{\Gamma(\alpha_1)\Gamma(\alpha_2)} \frac{w_1^{\alpha_1-1} (1-w_1)^{\alpha_2-1}}{(1-w_1)^{\alpha_1+\alpha_2-1}}
\end{aligned}$$

where the integral equals to 1 since the integral is once again a gamma distribution.

In fact, the $g_{w_1}(w_1)$ is a Beta distribution with the two parameters equal to α_1 & α_2

The REER is a trade-weighted index of a number of bilateral PPPs. Therefore, a REER against an economy's 8 major trading partners is

$$REER_t = PPP_{1,t}w_{1,t} + PPP_{2,t}w_{2,t} + \dots + PPP_{8,t}w_{8,t}$$

$$\text{and } w_{1,t} + w_{2,t} + \dots + w_{8,t} = 1$$

$$\text{Then } w_{8,t} = 1 - w_{1,t} - \dots - w_{7,t} \text{ and}$$

$$\begin{aligned}
REER_t &= PPP_{1,t}w_{1,t} + \dots + PPP_{8,t}(1 - w_{1,t} - \dots - w_{7,t}) \\
&= PPP_{8,t} + (PPP_{1,t} - PPP_{8,t})w_{1,t} + \dots + (PPP_{7,t} - PPP_{8,t})w_{7,t}
\end{aligned}$$

Therefore the variance of the $REER_t$ is

$$Var(REER_t) = (PPP_{1,t} - PPP_{8,t})^2 Var(w_{1,t}) + \dots + (PPP_{7,t} - PPP_{8,t})^2 Var(w_{7,t})$$

We can therefore calculate the 95% confidence bands for the REER (assuming REER is a normally distributed random variable).

$$95\% \text{ confidence band} = REER_t \pm 1.96 \sqrt{Var(REER_t)}$$

In fact, from a practical point of view, it is difficult to calculate the value of α_1 and α_2 . However, the easiest way to calculate $Var(w_{1,t})$ is to use the sample variance of the trade-weights since we already know their theoretical distribution. Charts 10 and 11 show the upper and lower 95% confidence bands, the new REERs and the fixed-weight REER for Singapore and Taiwan. We can therefore conclude that in both cases the fixed-weight REER is statistically significantly different from the moving-weight REER since the fixed-weight REERs have moved outside the confidence bands.

KOREA CYCLICAL SLOWDOWN INTENSIFIED BY THE NEED FOR RE- STRUCTURING.

Introduction

Following the marked economic slowdown of 1992 the Korean economy would appear to be in a position where it ought to be able to recover with reasonable vigour. Monetary growth (M2) has been accelerating since early 1993, interest rates have fallen substantially from their highs in 1991, the currency has become more competitive, and wage and price inflation have been brought under control. In addition, the opening of diplomatic relations with mainland China in August 1992 has touched off a rush of Korean investment in China which should help to revitalise some of those Korean industries whose competitiveness was damaged by the combination of Won appreciation in 1987-89 and strong wage increases in the late 1980s. Yet somehow the expected revival is still not materialising and GNP growth is wallowing below 5% in real terms -- lower than the lowest growth rates experienced in the 1984-85 slowdown.

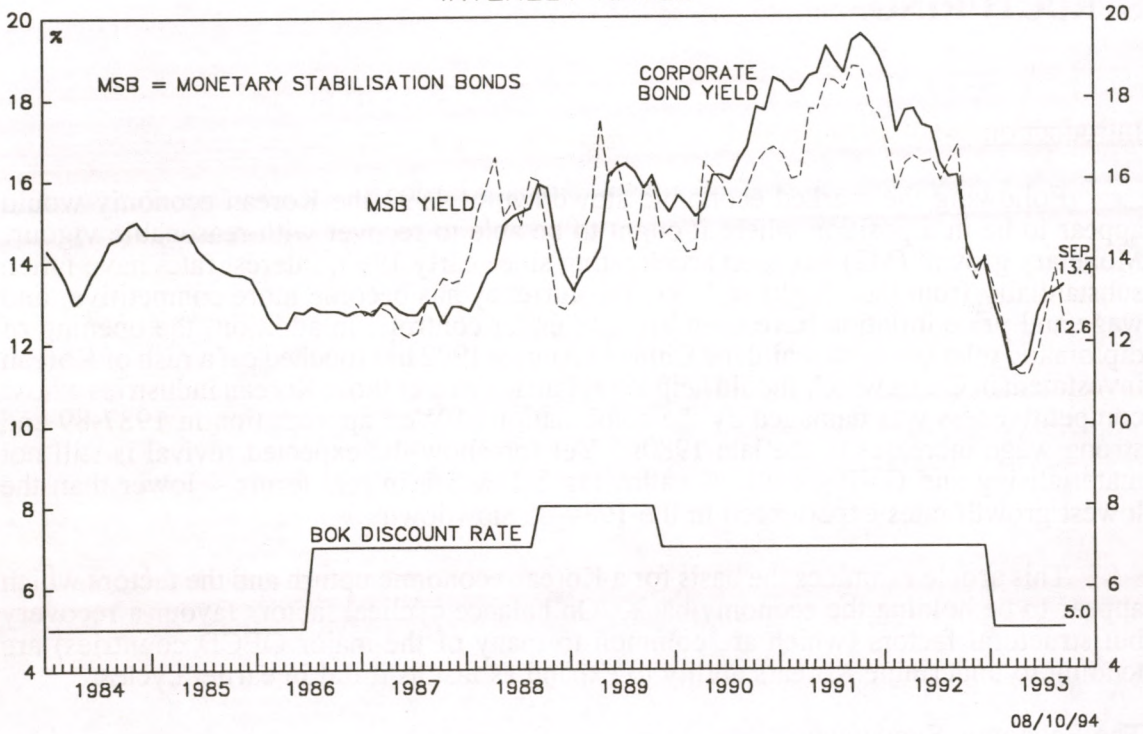
This article examines the basis for a Korean economic upturn and the factors which appear to be holding the economy back. On balance cyclical factors favour a recovery but structural factors (which are common to many of the major OECD countries) are tending to undermine Korea's ability to expand as fast as it did in earlier cycles.

The Economic Slowdown

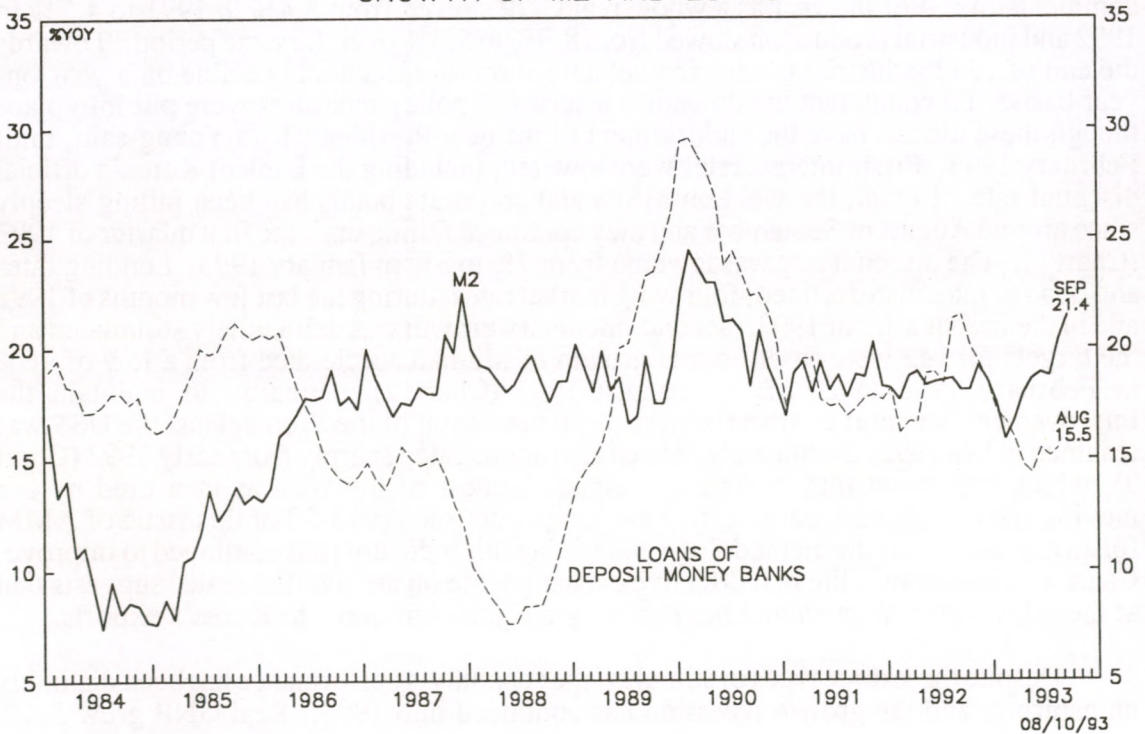
The economic slowdown of 1992 surprised and dismayed most Korean economic commentators. For the year as a whole real GNP slowed from 8.4% in 1991 to 4.7% in 1992 and industrial production slowed from 8.9% to 5.3% over the same period. Towards the end of 1992 industrial production actually showed a fractional decline on a year-on-year basis. To counteract the downturn a series of policy measures were put into place though these did not have the endorsement of the new President, Kim Young-sam, until February 1993. First, interest rates were lowered, including the Bank of Korea's official discount rate. In fact, the yield on MSBs and corporate bonds had been falling steeply since around August or September and they continued falling until the first quarter of 1993 (Chart 1). The discount rate was lowered from 7% to 5% in January 1993. Lending rates and deposit rates also declined, following market rates, during the last few months of 1992 and in the first quarter of 1993. Second, monetary growth was deliberately stimulated and the targets for M2 were eased so that growth of M2 had accelerated from a low of 16% in February 1993 to 20.3% by August 1993 (Chart 2). Finally, to maintain the improvement in export competitiveness the depreciation of the Won against the US\$ was resumed in late 1992. Fortunately the yen also appreciated sharply from early 1993 (Chart 3), which has meant that the overall competitiveness of the Won as measured by our moving trade-weighted real effective exchange rate (see pp.13-20 of this issue of AMM for an explanation of the methodology underlying this indicator) has continued to improve. Chart 4, which shows the real effective exchange rate on an inverted scale, suggests that at these levels the Won should be providing a significant boost to Korea's exports.

Despite these three types of stimulus, the economy's performance has been distinctly uninspiring, and the growth recession has continued into 1993. Real GNP grew 3.4%

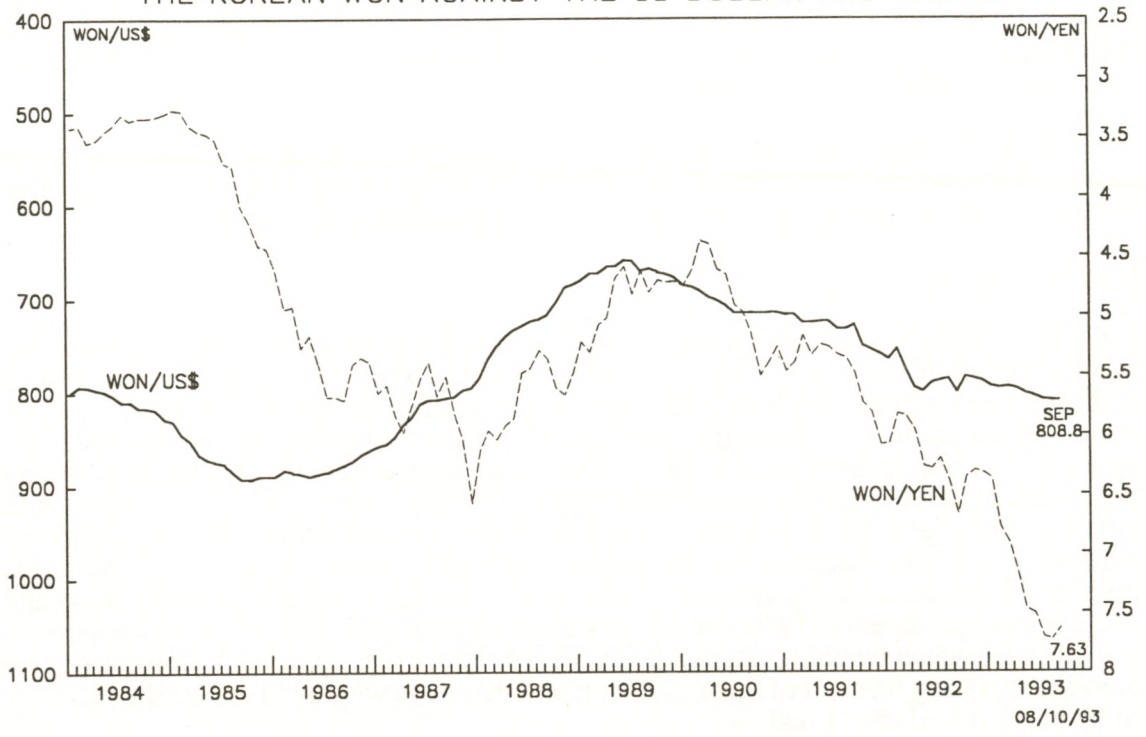
S. KOREA: CHART 1
INTEREST RATES



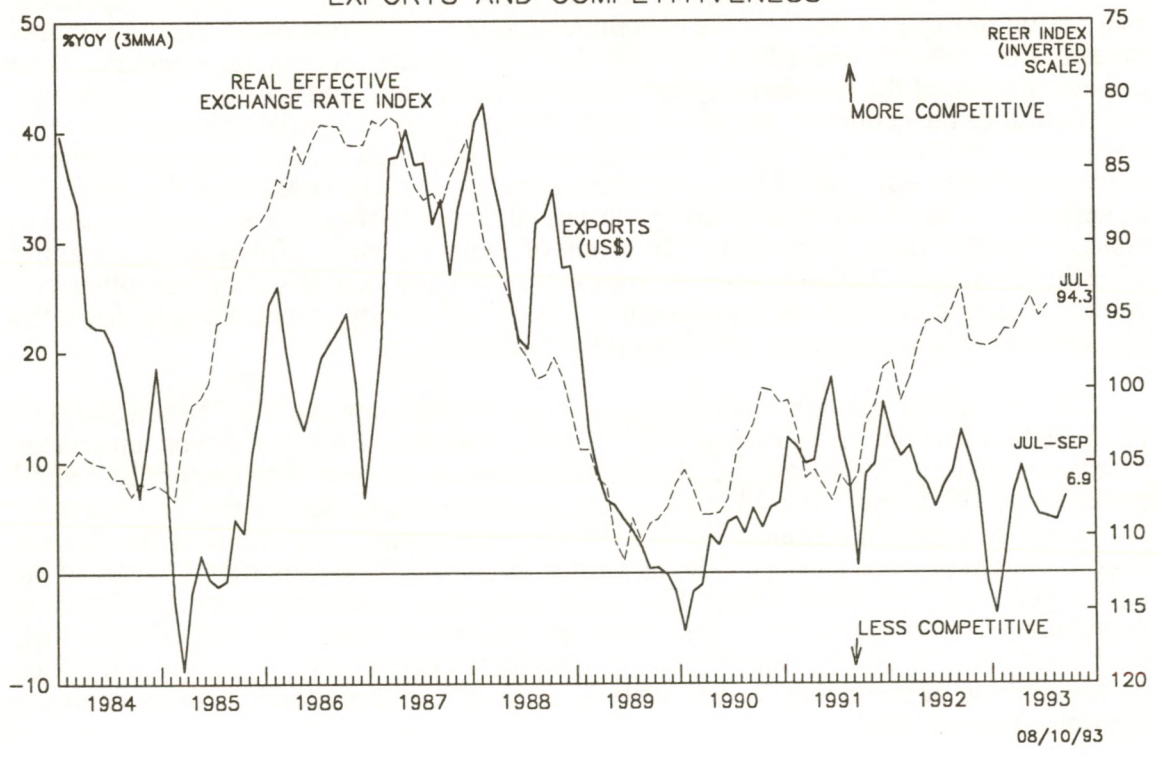
S. KOREA: CHART 2
GROWTH OF M2 AND LOANS



S. KOREA: CHART 3
THE KOREAN WON AGAINST THE US DOLLAR AND THE YEN



S. KOREA: CHART 4
EXPORTS AND COMPETITIVENESS



year-on-year in the first quarter and 4.2% in the second quarter of 1993. The slow pace of the recovery has continued in the third quarter with industrial production and shipments creeping along at 2-3% growth and the manufacturing sector as a whole remaining at less than 80% of full capacity utilisation. Recent GNP forecasts indicate that real growth may be as low as 4.0-4.3% for the year as a whole.

There are four main reasons why the economy has failed so far to respond to the stimulatory measures implemented in 1992 and in the early part of 1993, the first three being cyclical in nature, the fourth and last being more long term in nature.

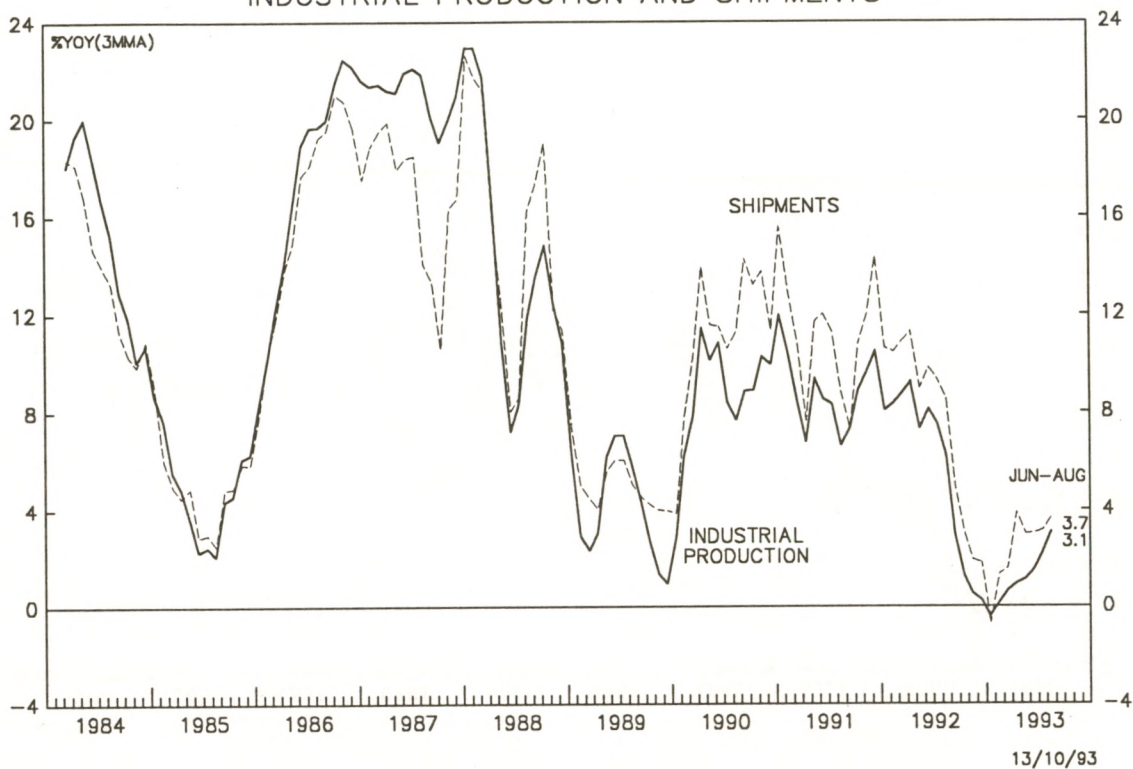
Cyclical Factors

(1) Even if the stimulatory measures were sufficient to fuel a strong economic upturn, it is too early to expect them to be fully effective yet. Experience in other countries and in Korea itself suggest that it requires close to a year of fairly aggressive stimulus to reinvigorate an economy. Although the bulk of the interest rate cuts came in late 1992, the upturn in M2 only began in early 1993, so one should not expect the impact from that on total spending or real GNP to come through until 1993 Q4 at the earliest. The upturn could possibly come later for a number of reasons -- e.g. an unexpected decline in income velocity, an adverse change in international competitiveness, a failure to solve the problems left over from the recession (such as high levels of corporate indebtedness and strained balance sheets of individuals), or a downward secular shift in the real economic growth rate (which would result in a much weaker than usual upswing.) In some degree Korea is suffering from all of these problems and therefore we should expect the recovery to be more muted than usual.

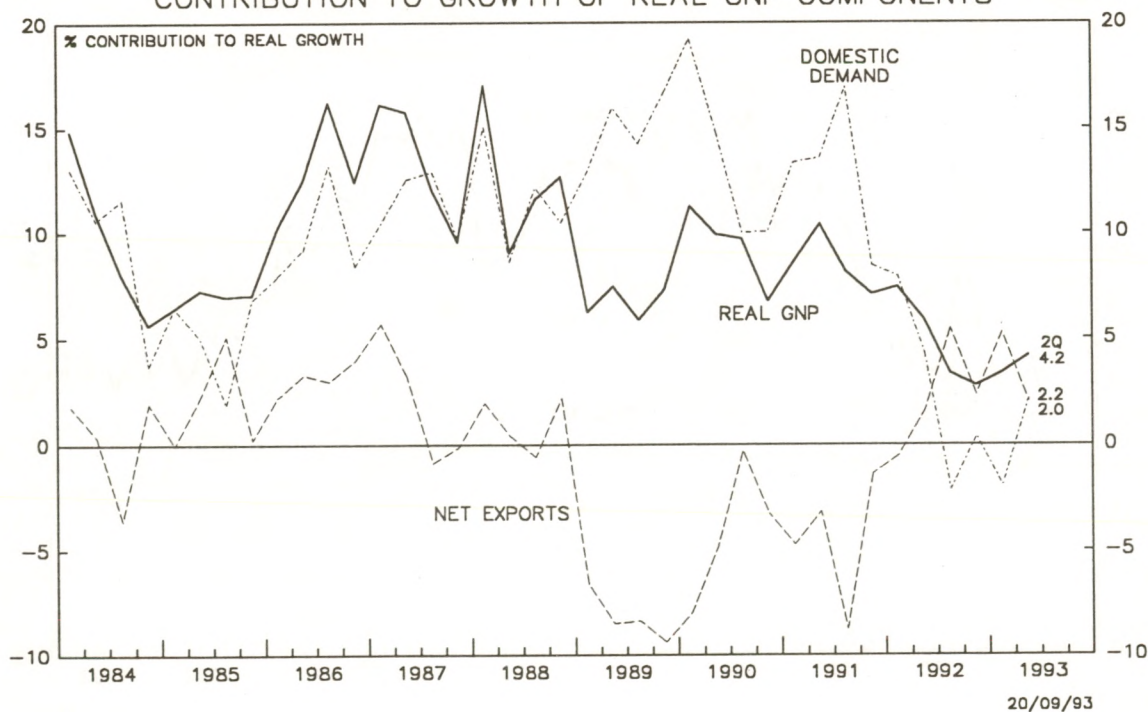
(2) The sudden announcement on August 12 of the implementation of the real name system by President Kim Young-Sam is of sufficient significance to be treated separately as a reason to expect a delay in the economic recovery. The real name system requires investors be properly identified and that they do not hide behind false names. The implementation of the real name system is undoubtedly valid and sensible for the longer term health of the economy, but in the short term it makes fund-raising harder for some companies, and hence will lead to some temporary reduction in plant and equipment or other capital expenditures. Moreover, the real name shock has paralysed the unofficial or kerb market for funds, thus freezing substantial amounts of capital as investors seek to conceal wealth from tax officials. In terms of their monetary effects these on-going investigations have led individuals to hold more cash and deposits than they otherwise would, resulting in a decline in the income velocity of money, hence slowing down the transmission of any monetary stimulus to the real economy.

A comparable episode which springs to mind was the impact of the "Nixon Shock" on the Japanese economy in August 1971. At that time then-President Nixon announced the closing of the gold window (i.e. the end of the formal convertibility for foreign central banks of the US dollar into gold at a fixed price, which at once forced the Yen and other currencies to appreciate against the US dollar), thus signalling the end of the Bretton Woods system of fixed parities. The upward revaluation of the Yen after 21 years at the unchanged parity of Yen 360 per US dollar constituted a drastic shock for Japanese manufacturers and exporters. They were so concerned about the risk of becoming uncompetitive at the new (Yen 308) exchange rate that capital investment virtually dried up for a period of six months or so. Only in early 1972 did economic activity resume a vigorous upward trend.

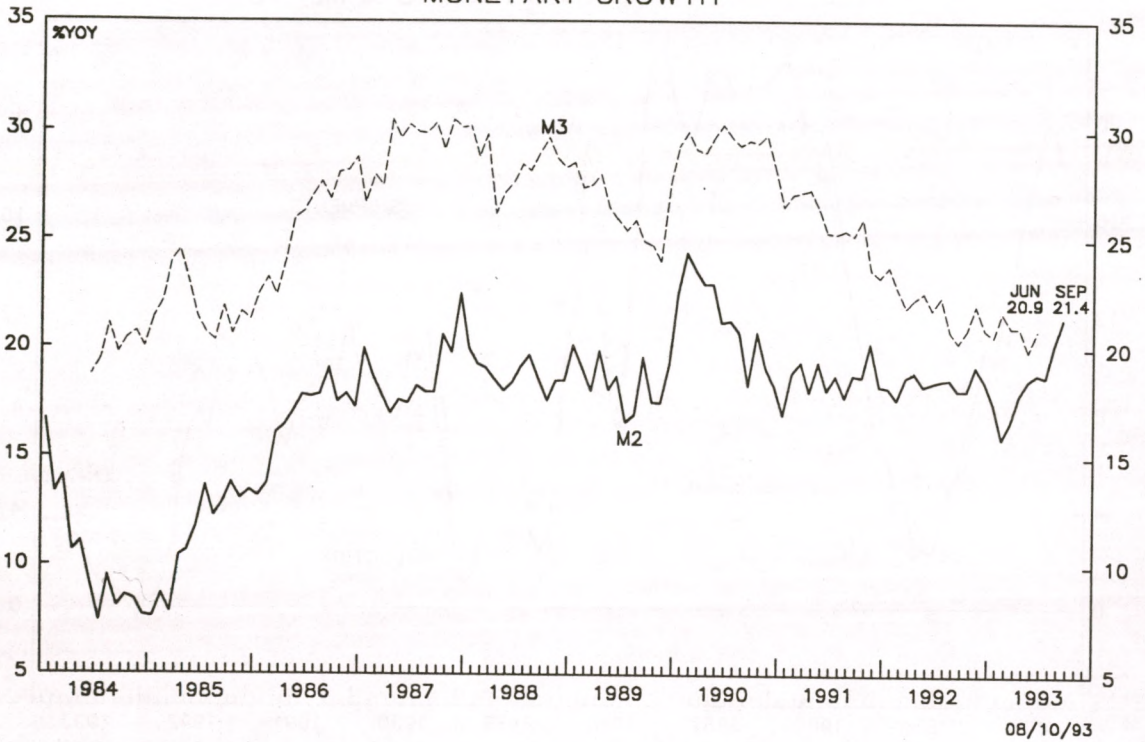
S. KOREA: CHART 5
INDUSTRIAL PRODUCTION AND SHIPMENTS



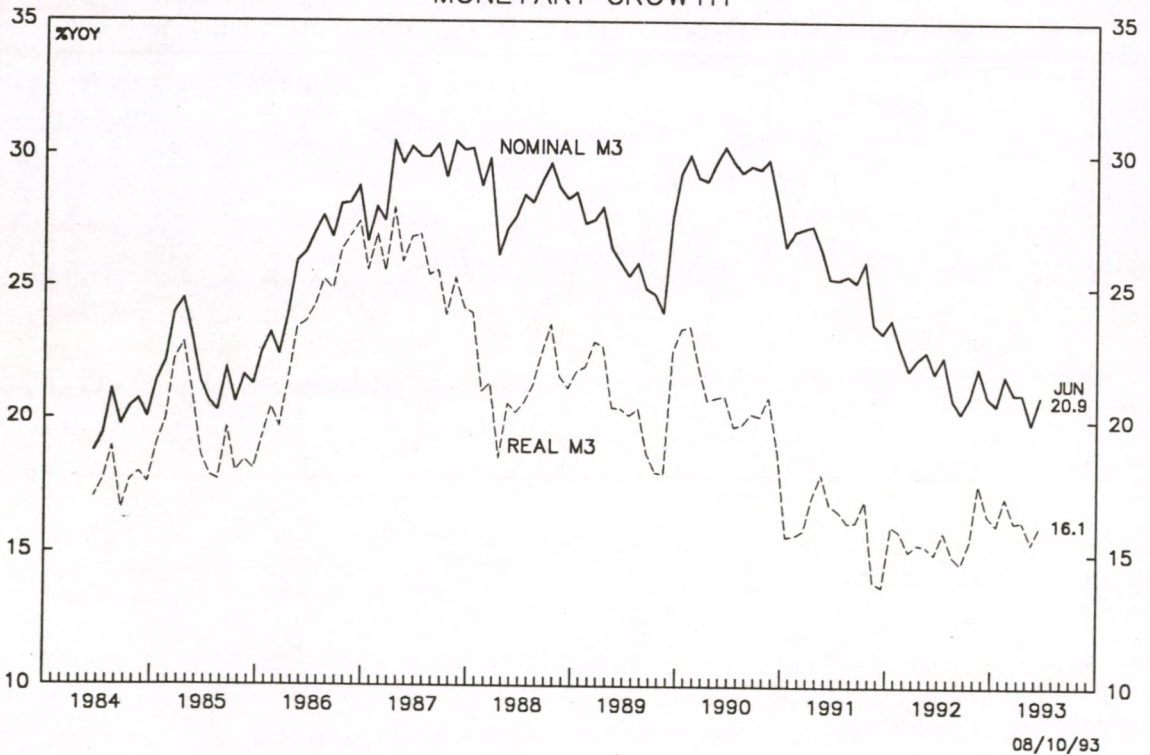
S. KOREA: CHART 6
CONTRIBUTION TO GROWTH OF REAL GNP COMPONENTS



S. KOREA: CHART 7
MONETARY GROWTH



S. KOREA: CHART 8
MONETARY GROWTH



Returning to the case of Korea in 1993, we expect the real name problem will lead to a temporary decline in income velocity, a delay in the transmission of monetary stimulus to spending and real GNP, and possibly the introduction of further stimulatory measures to boost the economy in the coming months.

(3) A third reason for doubt about the ability of the Korean economy to respond to the recent series of stimulatory measures is that despite the reduction in interest rates, despite the acceleration in M2, and despite the improvement in the trade and current accounts of the balance of payments, M3, the broadest official measure of money which is three times the size of M2, has entirely failed to turn upwards. Indeed, as shown in Chart 7, M3 decelerated continuously from late 1990 until mid-1992, and since then it has only levelled out at 21-22% rather than shown any acceleration. In fact, the profile of M3 for Korea is strongly reminiscent of the general profile of M2 for Indonesia which has also experienced a sub-par recovery so far even though Indonesia has benefited from a much longer period of steady money growth. Also, as shown in Chart 8, the decline in inflation has meant that real money growth remained in the 15-17% range for two and a half years. The economic slowdown of 1992-93 is consistent with the downturn in real M3 growth in 1990-91 and as yet there has been no sustained upturn in real M3.

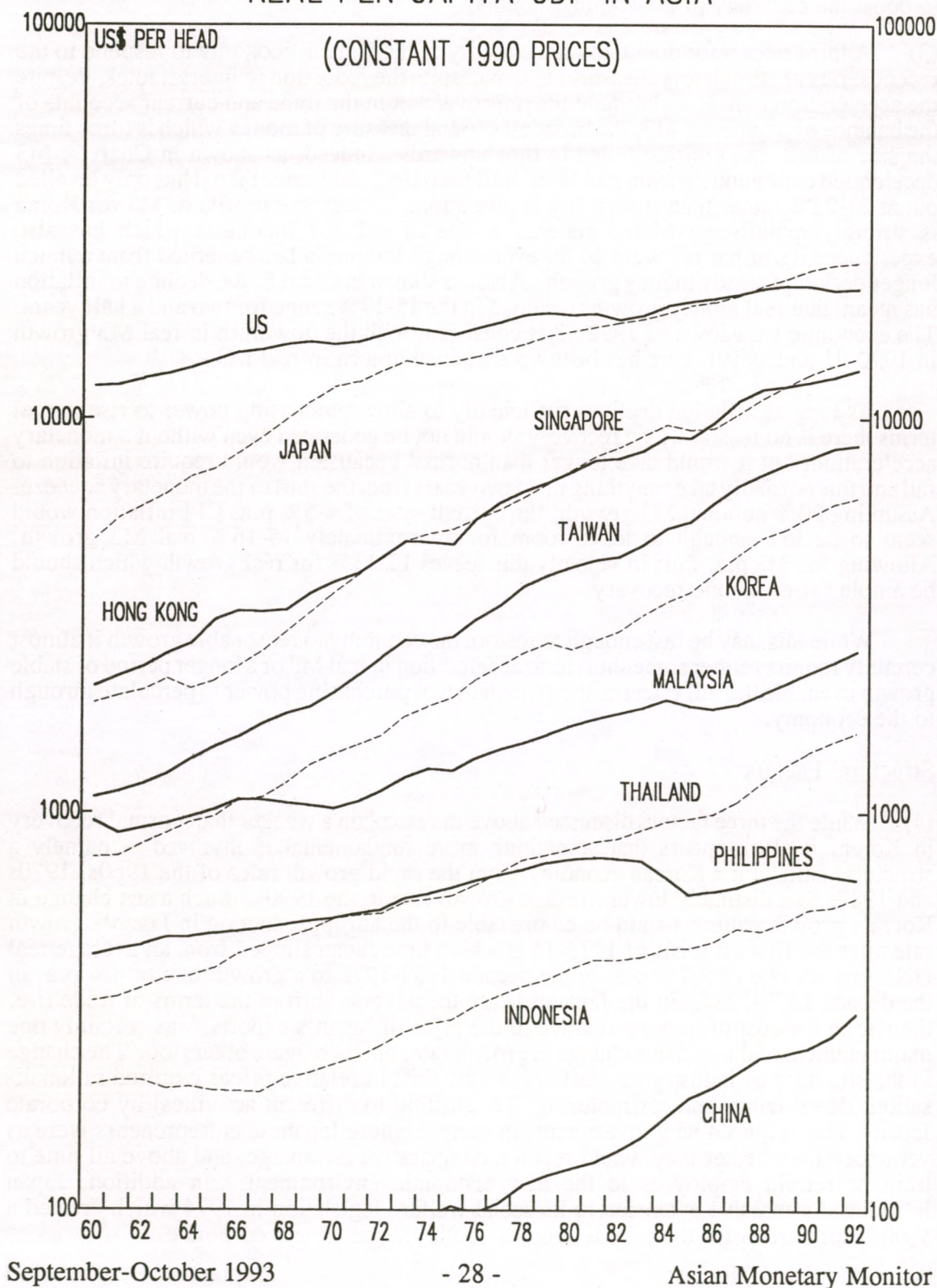
As long as inflation declines sufficiently to allow purchasing power to rise in real terms there is no reason why a recovery should not be generated even without a monetary acceleration, but it would take longer than normal because it would require inflation to fall and this normally takes anything up to two years from the start of the monetary squeeze. Assuming 20% nominal M3 growth, the current rates of 4-5% p.a. CPI inflation would seem to be low enough to leave room for approximately 15-16% real M3 growth. Allowing for 3% p.a. falls in velocity this leaves 12-13% for real growth which should be ample for economic recovery.

While this may be fast enough to restore the economy to reasonable growth it almost certainly requires either some short term acceleration in real M3 or a longer period of stable growth to enable the full effect of the growth in real purchasing power to percolate through to the economy.

Structural Factors

(4) While the three factors discussed above may explain a weaker than normal recovery in Korea, it also appears that something more fundamental is involved -- namely a structural shift in the Korean economy from the rapid growth rates of the 1960s, 1970s and 1980s to a distinctly lower average growth rate in the 1990s. Such a sea change in Korea's growth pattern would be comparable to the abrupt reduction in Japan's growth rate after the first oil crisis of 1973-74 at which time Japan slipped from an average real GNP growth rate of 9.7% p.a. in the decade 1963-1972 to a growth rate of 4% p.a. in the decade 1973-1984. In the Japanese case the adverse shift in the terms of trade (i.e. the rise in the cost of imports relative to the price of Japan's exports) was certainly one major element of the decisive change in growth rate, but there were others too. The change in the structure of industry necessitated by the shift in relative prices required rationalisation, downsizing, and restructuring (i.e. shifting to different activities) by corporate Japan. This required new investments in sectors where Japanese entrepreneurs were as yet uncertain whether they would retain a comparative advantage, and above all time to train or retrain employees to the new economic environment. In addition, Japan introduced a massive extension to its social welfare legislation in 1974 which created a significant burden for the private sector -- both individual and corporate.

S. KOREA: CHART 9 REAL PER CAPITA GDP IN ASIA

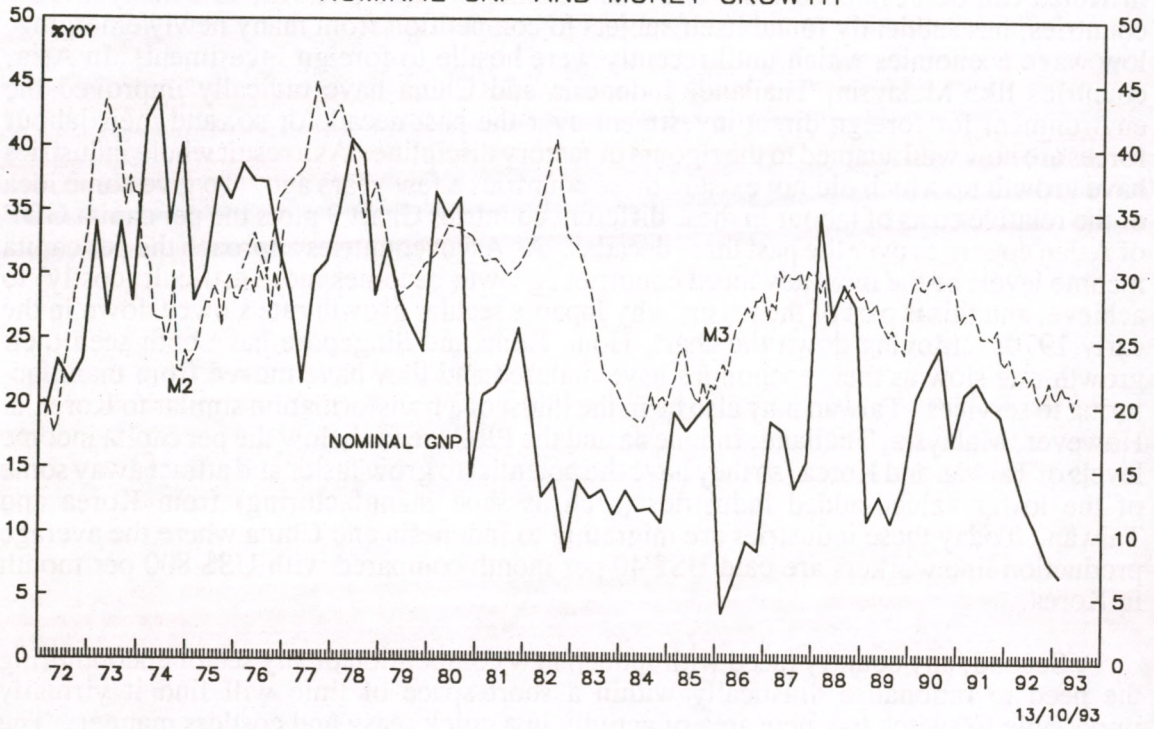


The basis for such a structural adjustment to a lower long term average growth rate in Korea can be developed from two main elements. First, Korea, like many OECD countries, has suddenly found itself subject to competition from many newly emerging, low wage economies which until recently were hostile to foreign investment. In Asia, countries like Malaysia, Thailand, Indonesia and China have radically improved the environment for foreign direct investment over the past decade or so, and their labour forces are now well adapted to the rigours of factory discipline. As a result whole industries have grown up which did not exist in these countries a few years ago. To give some idea of the relative costs of labour in these different countries Chart 9 plots the per capita GDP of Asian countries over the past three decades. As Asian countries approach the per capita income levels of the most advanced countries, growth becomes more difficult (costly) to achieve, and this is part of the reason why Japan's secular growth rate slowed down in the early 1970s. Moving down the chart, Hong Kong and Singapore have both seen their growth rate slow as their economies have matured and they have moved from manufacturing to services. Taiwan may also be in the midst of a transformation similar to Korea's. However, Malaysia, Thailand, Indonesia and the PRC are far below the per capita income levels of Taiwan and Korea, so they have the potential to grow faster and attract away some of the lower valued-added industries (such as shoe manufacturing) from Korea and Taiwan. Today these industries are migrating to Indonesia and China where the average production line workers are paid US\$ 40 per month compared with US\$ 800 per month in Korea.

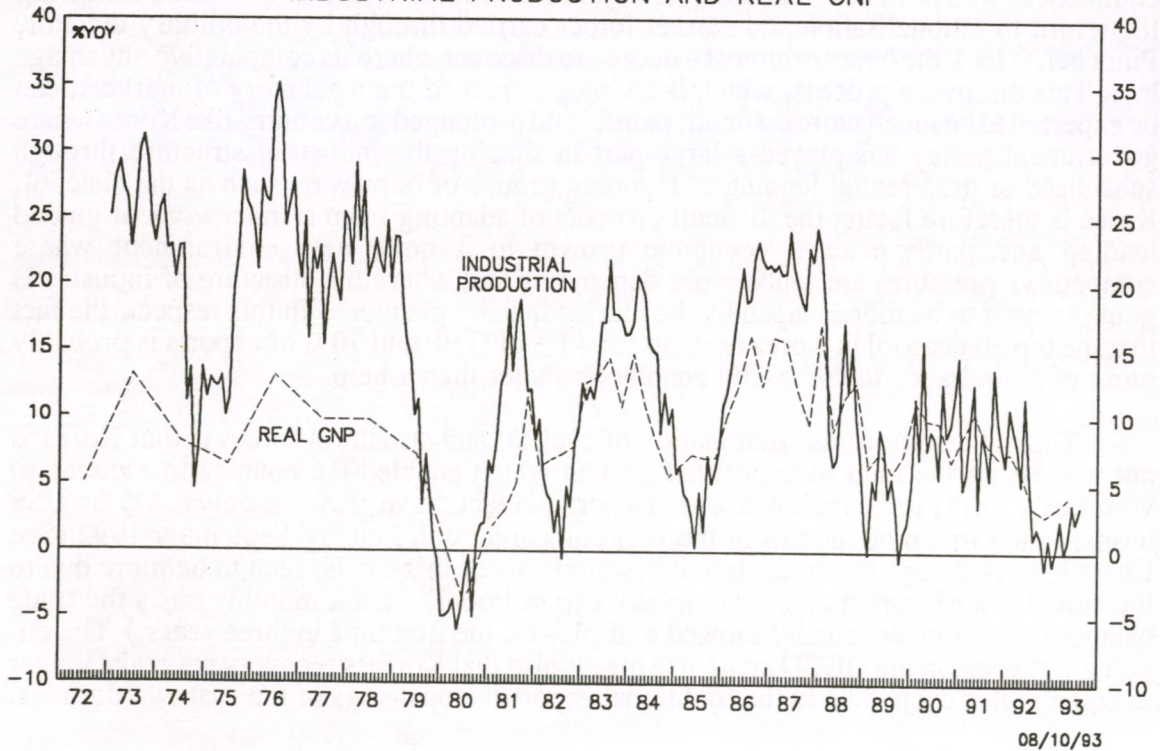
Second, any country faced with sudden new competition or any sector encountering the need to rationalise drastically within a short space of time will find it virtually impossible to switch to a new area of activity in a quick, easy and costless manner. The process of adjustment to the new circumstances requires progressive adaptation, trial and error experiments with new products or new services, and large investments in new capital equipment as well as in new marketing tools and techniques. In the case of Chile following the return to rationalisation and market forces carried through by the military dictator, Pinochet, it took the country almost a decade to discover where its comparative advantage lay. This discovery process, which is an integral part of the machinery of markets, can be expected to be much more difficult, painful and prolonged in a country like Korea where government policy has played a large part in shaping the industrial structure through subsidised or preferential lending to favoured groups of borrowers such as the chaebol. Korea is therefore facing the difficult prospect of adapting from a framework of guided lending and partly-planned economic growth to a quite new environment where competitive pressures are much more demanding and where the structure of industry is going to need to be more shaped by the market than by planners. In this respect, the fact that the top 30 chaebol in Korea account for 43% of GNP and 70% of exports is probably more of a hindrance to successful adaptation rather than a help.

The net result of this combination of cyclical and structural forces is that Korea is not witnessing the kind of export-led growth which enabled the country to recover so vigorously from previous slowdowns. Exports, in fact, have grown at only 6.4% (in US\$ terms) in the first nine months of the year compared with January-September 1992 (See Chart 12). Although the trade deficit has diminished, this can be seen to be more due to the slowdown of imports than due to any export boom. (On a monthly basis the trade balance in September actually showed a surplus for the first time in three years.) The ongoing weakness in the OECD areas also means also that Korea's recovery may take longer to come in this cycle than in the traditional export-led upswings of the past two decades.

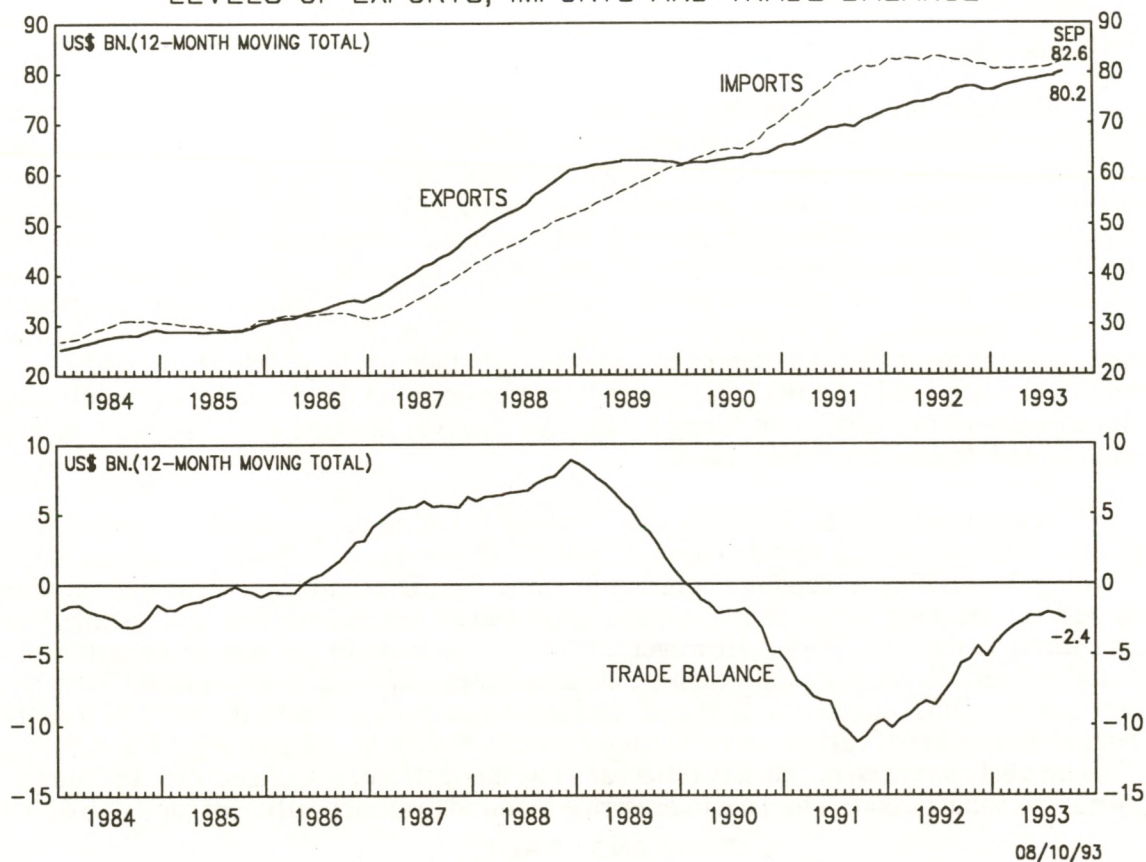
S. KOREA: CHART 10
NOMINAL GNP AND MONEY GROWTH



S. KOREA: CHART 11
INDUSTRIAL PRODUCTION AND REAL GNP



S.KOREA: CHART 12
LEVELS OF EXPORTS, IMPORTS AND TRADE BALANCE



SUMMARY AND FORECAST: Korea's economy grew at a disappointingly low rate of 4.7% in 1992 and looks like growing even more slowly in 1993, despite a series of stimulative measures taken by the authorities since late 1992. These deliberate policy measures have so far been ineffective in part because the time lag between monetary policy actions and their impact on the economy means they may not have been in place for long enough yet; in part because they have not succeeded in turning M3 from deceleration to stability or mild upturn; and partly on account of the implementation of the real name scheme for financial transactions (because this will tend to lower income velocity and thus slow the normal transmission of any monetary stimulus to the real economy). However, a more pervasive and fundamental problem facing the Korean economy is the emergence of new, low cost competitors in the Asian region such as Indonesia and China. Given Korea's rather rigid economic framework, notably the chaebols and the compartmentalised financial system, and a history of very active government planning or guidance, it will be especially hard for Korea to adapt to the new environment. The transition period to a revised economic structure could be lengthy, and Korea's ability to experience a new era of a rapid economic growth rate, even when it does recover, is somewhat dubious at best, and will in any case require a considerable restructuring of both Korea's industrial structure and a thorough overhaul and deregulation of Korea's financial markets. Hopes of an early and strong revival could therefore be disappointed.

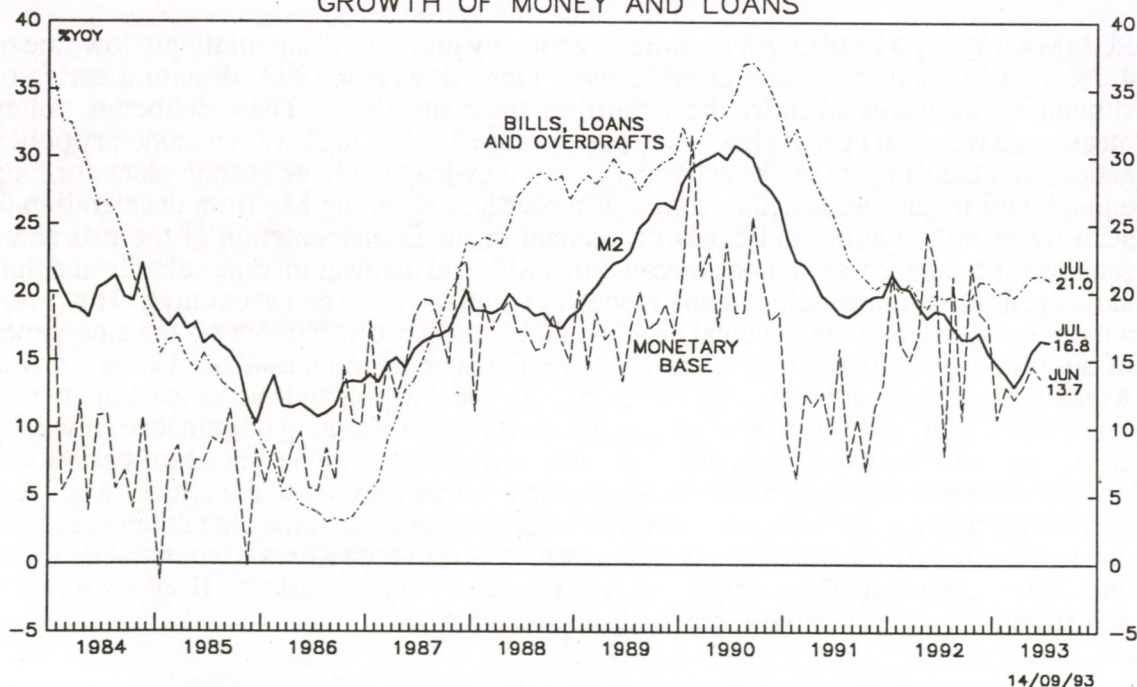
THAILAND EXTERNAL CONSTRAINT SPELLS MODEST RECOVERY

Introduction

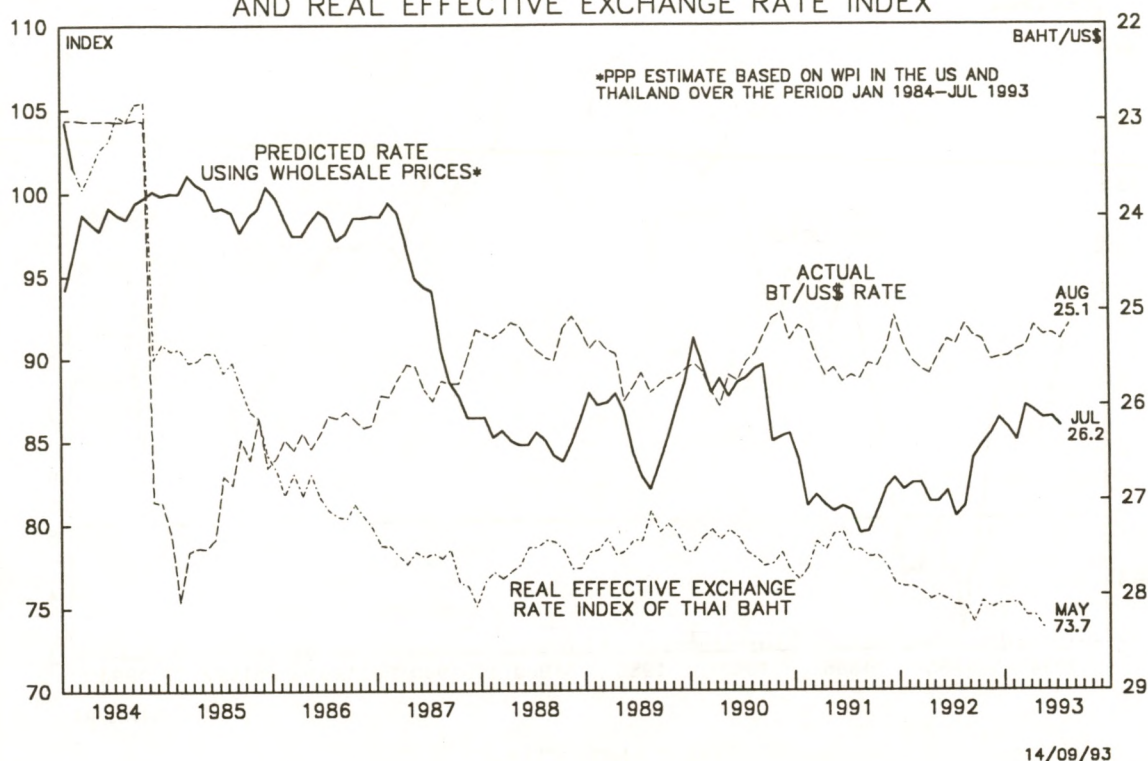
Thailand has developed rapidly over the last decade experiencing real economic growth in excess of 15% in 1988 and 1989. In common with many of its East Asian neighbours much of the source of this growth has been external in origin. Whether because of improvements in the trade or in its capital accounts, whenever Thailand has experienced significant prolonged increases in its net foreign exchange reserves position, an expansion in its monetary base and broader money aggregates has occurred. This is because the Bank of Thailand (BOT) has followed either a heavily managed or fixed exchange rate policy since the collapse of the Bretton Woods System back in 1973. Although it has had to devalue or allow the Baht to depreciate 3 times since then (in July 1981, November 1984 and December 1985) the BOT has typically preferred to let the domestic economy take the adjustment to a change in foreign exchange reserves through a change in monetary growth and domestic inflation rates.

In this article it will be shown that Thailand is still in the process of recovery after a tremendous monetary slowdown over 1991-92 (Chart 1). It is having to adjust to the ongoing downswing in economic growth in many OECD economies. This will be seen to be a constraining factor on its own real GDP and export growth over the rest of 1993 and through most of 1994. However Thailand continues to be able to benefit from sustained net inflows of capital which are attracted by the Thai-US interest rate differential. Because the BOT operates a managed exchange rate policy where the Baht is loosely pegged to a basket of currencies (including the US\$, Yen, DM, Pd. sterling, S\$ and HK\$), Thai interest rates need not closely reflect any one interest rate, associated with a particular currency in that basket. The Thai interest rate required to attract sufficient capital to offset

THAILAND: CHART 1
GROWTH OF MONEY AND LOANS



THAILAND: CHART 2
ACTUAL AND PREDICTED BAHT/US\$ RATE
AND REAL EFFECTIVE EXCHANGE RATE INDEX

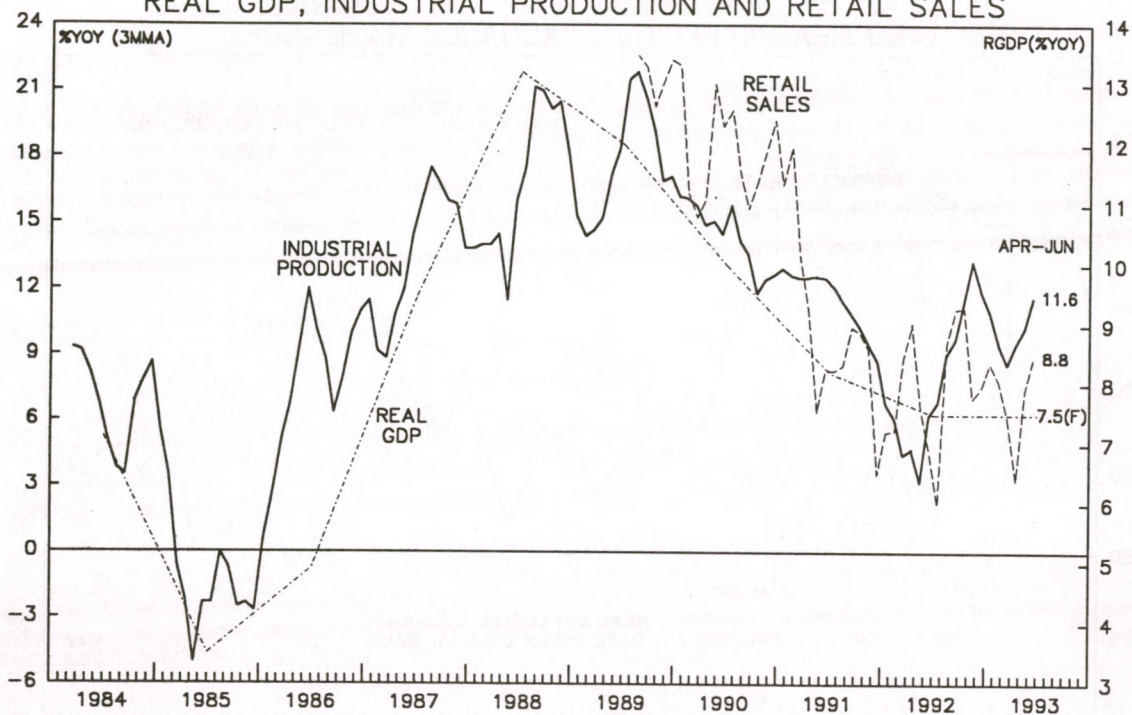


the present current account deficit can be thought of as some weighted average of those which apply to the currencies within the basket. As will be seen this has not prevented Thai interest rates from following the decline in US interest rates from 1991 onwards. This article begins with a brief review of Thailand's current monetary cycle, before examining how the monetary base and broader deposits growth have been influenced over 1986-90. Finally, the current state of the real economy and the sources of future monetary growth are considered.

A brief review of Thailand's monetary cycle up to 1990

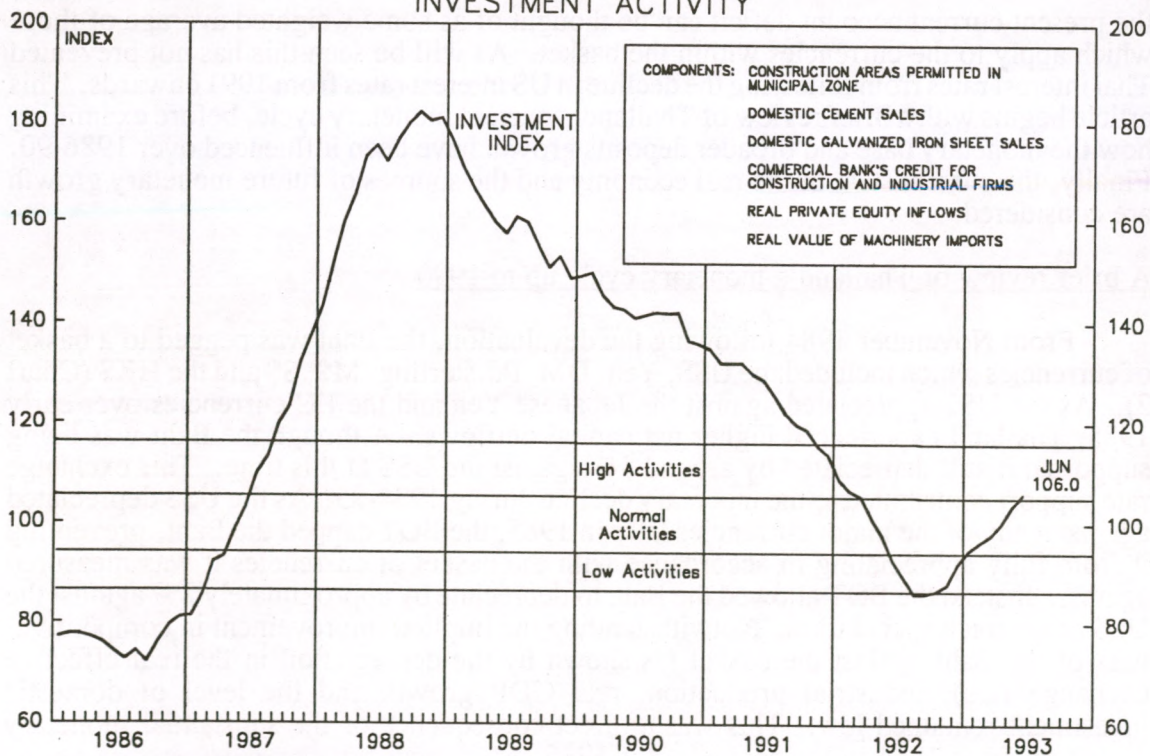
From November 1984 following the devaluation, the Baht was pegged to a basket of currencies which included the US\$, Yen, DM, Pd. sterling, M\$, S\$ and the HK\$ (Chart 2). As the US\$ appreciated against the Japanese Yen and the EC currencies over early 1985, Thailand experienced higher net capital outflows. Although the Baht was being supported it still depreciated by around 5% against the US\$ at this time. This exchange rate support contributed to the monetary decline during 1984-85. As the US\$ depreciated against many of the major currencies later in 1985, the BOT capped the Baht, preventing it from fully appreciating in accordance with the basket of currencies it was measured against. Instead the BOT allowed the Baht to depreciate by approximately 2% against the US\$ amid much speculation. Notwithstanding the implied improvement in competitiveness of the Baht against the basket (as shown by the depreciation in the real effective exchange rate), industrial production, real GDP growth and the level of domestic investment remained low. This was a direct consequence of the substantial monetary downturn from 1984 to the beginning of 1986.

THAILAND: CHART 3
REAL GDP, INDUSTRIAL PRODUCTION AND RETAIL SALES



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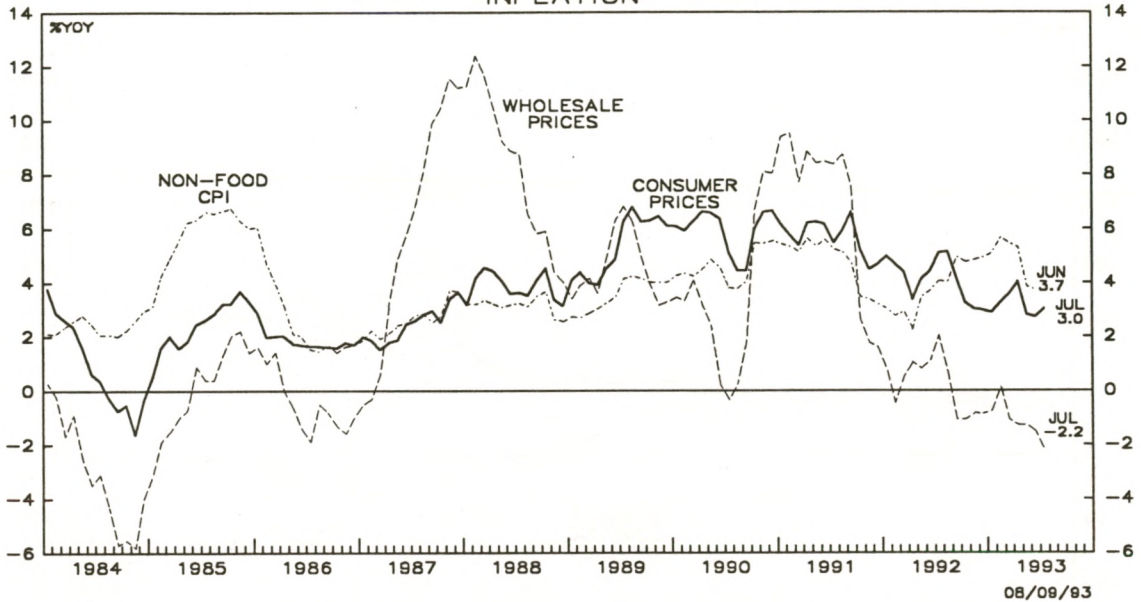
THAILAND: CHART 4
INVESTMENT ACTIVITY



SOURCE: BANK OF THAILAND

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THAILAND: CHART 5
INFLATION

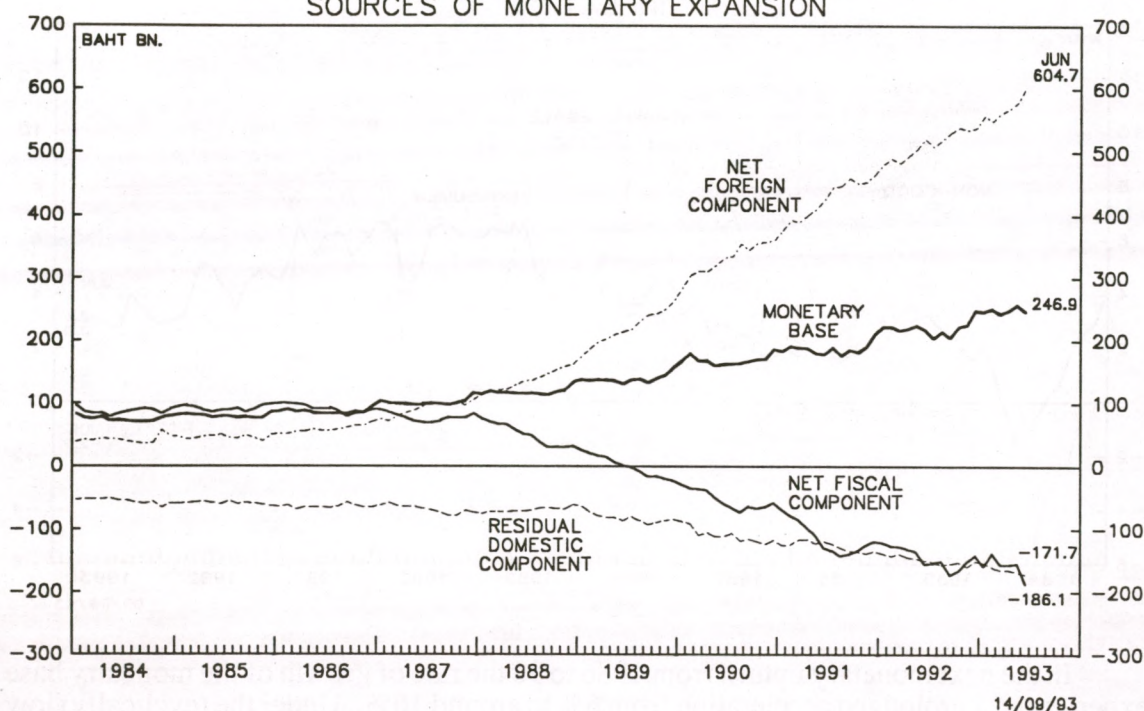


In the next monetary upturn from 1986 to 90 the rate of growth of the monetary base experienced a prolonged acceleration from 6% to around 16%. Under the (cyclically) low lending rates then prevailing, this led to a substantial upswing in broad money supply and credit growth (Chart 1). M2 accelerated from around 15% yoy in 1986-87 to a maximum of around 30% in 1990. Credit growth exhibited an even more dramatic acceleration from around 10% to over 35% in the same time period. This monetary upswing led to a sharp and sustained expansion in the growth of real GDP, industrial production and investment from 1986 to 1988 (Charts 3 and 4). As one would expect the rates of wholesale and consumer inflation rose soon afterwards reaching a climax in 1990. The rate of consumer price inflation (both including and excluding the volatile food component) rose steadily from 2% in 1986 to 5-6% in 1990 (Chart 5). Wholesale price inflation, being more volatile initially accelerated sharply from a rate of around -1% growth to over 12% in 1987. Thereafter, it fluctuated slightly less wildly averaging around 5% growth up to 1990. The initial steep rise and subsequent collapse in wholesale prices is a reflection of the short term rigidities in the supply of intermediate and capital goods whenever firms try to meet higher demand with existing capacity. The monetary base and the factors influencing it over the late 1980s will now be examined before considering the most recent monetary developments.

Monetary Base Analysis

Changes in the monetary base can be seen in terms of changes in items on the assets side of the Central Bank's balance sheet. The Central Bank holds foreign assets and domestic assets. Domestic assets are comprised of Central Bank claims on the government (holdings of government debt) and open market loans to the banking and financial sector of varying lengths to maturity. Chart 6 shows, in levels, net foreign assets, net claims on the government and a residual domestic asset component. When added altogether these components give a value for the level of the monetary base. The major point to notice about the monetary base in Thailand is the emergence in importance of the net foreign assets component and a corresponding decline in the overall domestic component for any

THAILAND: CHART 6
SOURCES OF MONETARY EXPANSION



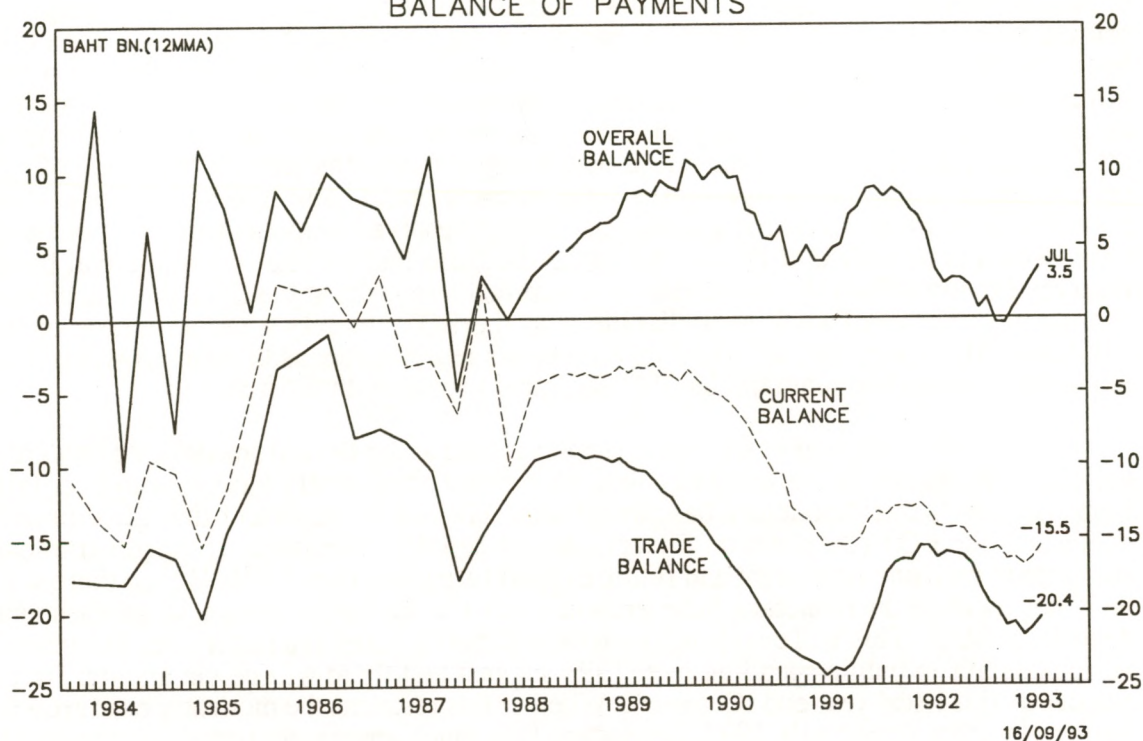
given level of the monetary base after 1987. This came about for two main reasons. Firstly and most significantly, there was an improvement in Thailand's balance of payments position from 1987 to 1990 (Chart 7). Over this time, the rapid expansion in net foreign assets was the major upward force behind the higher growth in the monetary base. Secondly, since 1987-88, the government has run a string of budget surpluses, which, for the most part have been held at the Bank of Thailand. This means that BOT net claims on the government (holdings of government bonds less government deposits at the BOT) have declined over the late 1980s. It will be shown that this has had a contractionary influence on the monetary base. We now consider these two factors more closely.

The Fiscal Surplus: How the monetary base and M2 deposits are affected

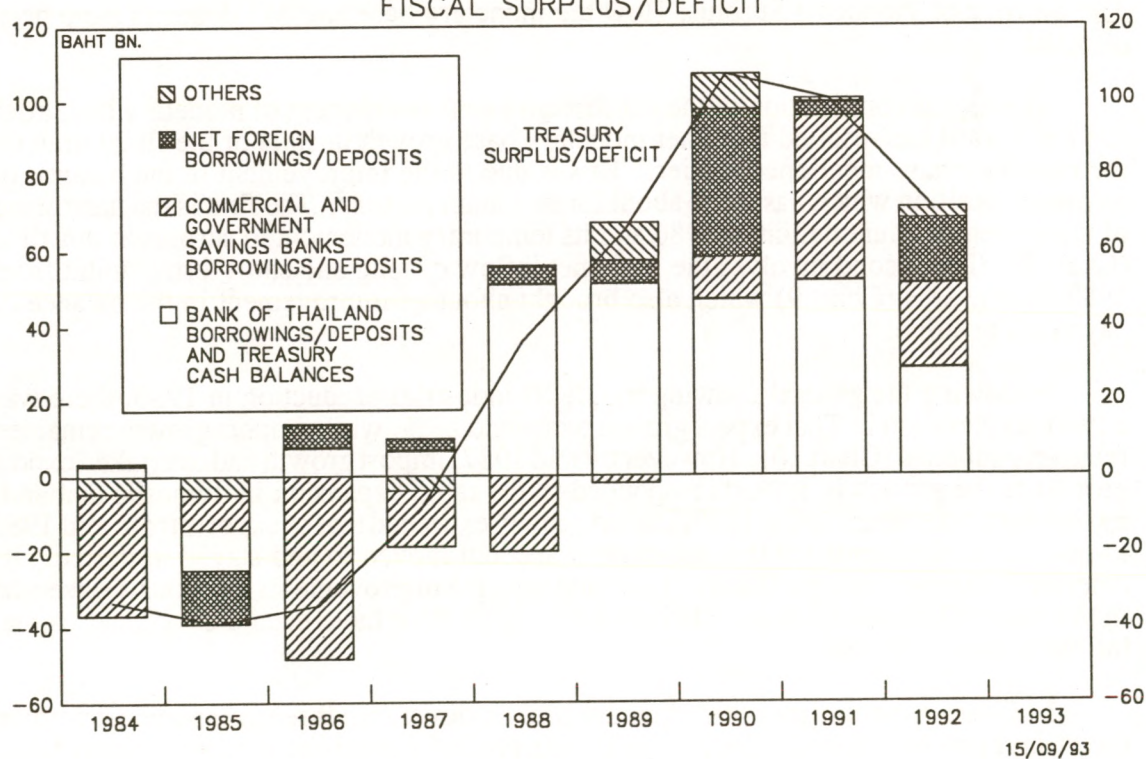
On the fiscal side, central government deficits averaging 7% of GDP in the early 1980s, gave way to surpluses of around 4% of GDP from 1988 onwards. Chart 8 shows how the fiscal deficits previous to 1987 were financed and where the fiscal surpluses have since been deposited. Clearly a substantial proportion of the government surpluses have been kept at the BOT (shown as positive BOT borrowings and treasury cash balances). However a sizeable fraction of these surpluses has also been held in commercial and government banks (shown as positive commercial and government savings banks borrowings) over the last couple of years. How can the accumulation of government deposits either at the central bank or in the commercial banking system have affected the rate of base and broad money growth since 1987?

If the government deposits are increased in the commercial banking sector private entities have to hold less deposits at private banks (net taxes collected rises). However at the same time government deposits in the banking sector rise by an offsetting amount. Thus there is no net change in the total level of deposits in the commercial banking system.

THAILAND: CHART 7
BALANCE OF PAYMENTS



THAILAND: CHART 8
FISCAL SURPLUS/DEFICIT



The case where the government increases its deposits at the central bank can be broken down into two stages. In the first stage, because of the rise in the fiscal surplus, private deposits fall at the commercial banks and the government deposits at the central bank rise by a corresponding amount. This lowers the central bank's net claims on the government (holdings of government debt - government deposits) and the total domestic assets component of the monetary base falls. In the second stage the commercial banks are forced to call in or reduce the rate at which they create loans because the action of the private sector withdrawing its deposits reduces commercial bank reserves. This entails a decline in the (consolidated) commercial banks' reserve component of the monetary base, which is deposited at the central bank. Because this decline in commercial bank reserves exactly offsets the initial rise in government deposits at the BOT there is no net change in the level of total assets/liabilities at the BOT, merely a redistribution in its liabilities. However, the fall in commercial banks reserves means that the growth of the monetary base and commercial bank (Thai Baht) loan growth must shrink.

The accumulation of yearly fiscal surpluses held at the BOT from 1987-88 onwards has been a factor which has acted as a drag on the rate of monetary base growth over this time. In 1992, this "monetary base drag" was relieved to the extent that government deposits at the BOT (the drain on financial sector deposits) declined. If the government succeeds in realising its current and future expenditure plans over 1993-94 then there will be a net increase in monetary base growth from the further rundown in government deposits at BOT. This will enable banks to extend their lending at a faster rate. However, various delays in public spending over 1993 suggest that there will be yet another fiscal surplus by this fiscal year end (October). Whether this restrains the monetary base growth more or less than occurred in 1992, depends on how much government deposits at the BOT are changed.

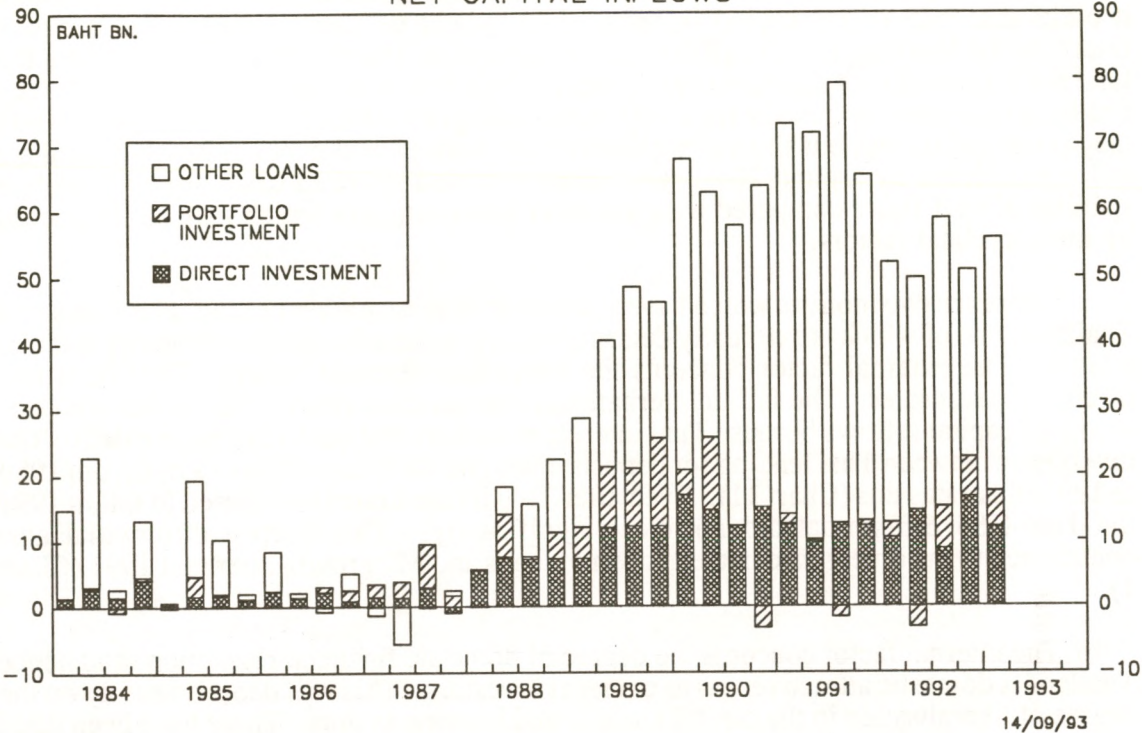
The Balance of Payments Surplus: How the monetary base and M2 deposits have been affected

The higher contribution of the net foreign assets component of monetary base after 1987 (Chart 6) has resulted in higher monetary base growth in spite of the fiscal drag on the monetary base mentioned earlier. This is due to the improvement in the balance of payments position which has come about for two main reasons. The first is the narrowing of the current account deficit in 1986 and its temporary movement to surplus at this time (Chart 7). The second involves the rapid net inflow of long and short term capital from 1988-89 onwards (Chart 9) which also brought about an improvement in the balance of payments position.

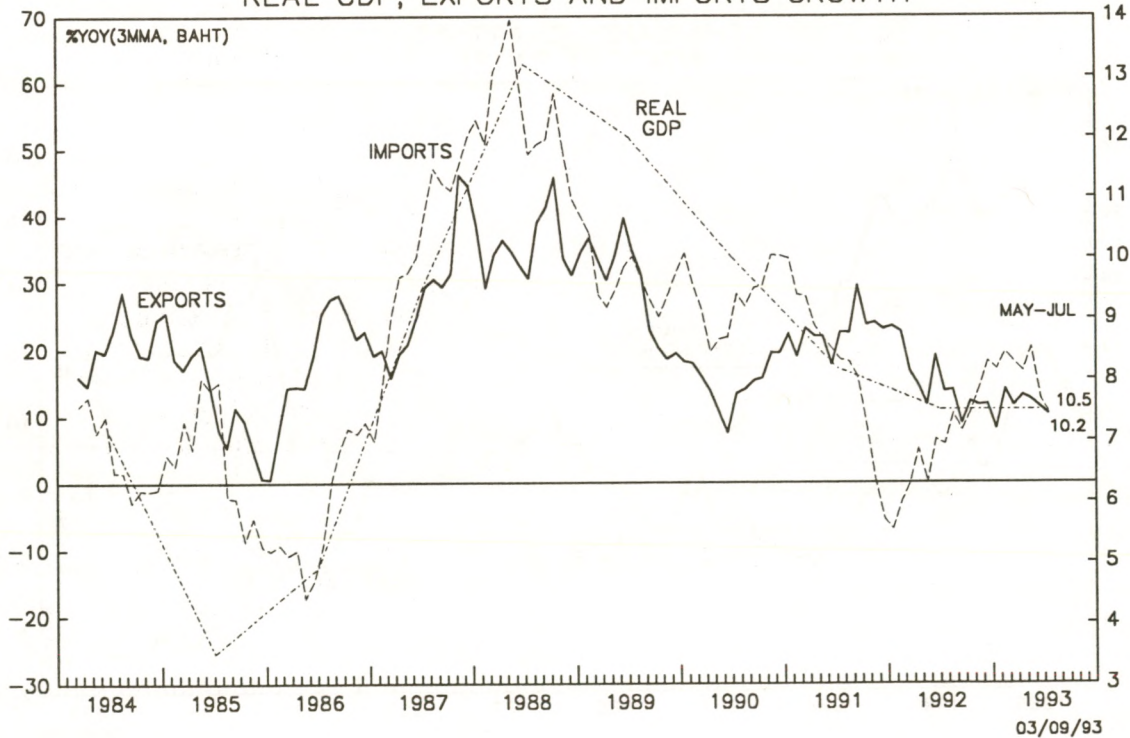
Following the general upswing in OECD industrial production in 1986, there was a swift acceleration in Thai export growth to around 25%, while import growth remained relatively subdued (Chart 10). However by mid 1987, import growth had overtaken export growth as the growth in imports responded to the rapid expansion in domestic demand. Except for a brief time during 1989, import growth exceeded that of exports from mid 1987 to mid 1991. This ensured that the current account moved to and stayed in deficit. Its deterioration over this time (Chart 7) coupled with the improvements previously observed in the overall balance of payments imply that there must have been a strong net capital inflow around this time.

In Chart 9, net inflows of capital are broken down into three components: foreign direct investment (generally long term flows) portfolio investment (shorter term flows

THAILAND: CHART 9
NET CAPITAL INFLOWS



THAILAND: CHART 10
REAL GDP, EXPORTS AND IMPORTS GROWTH

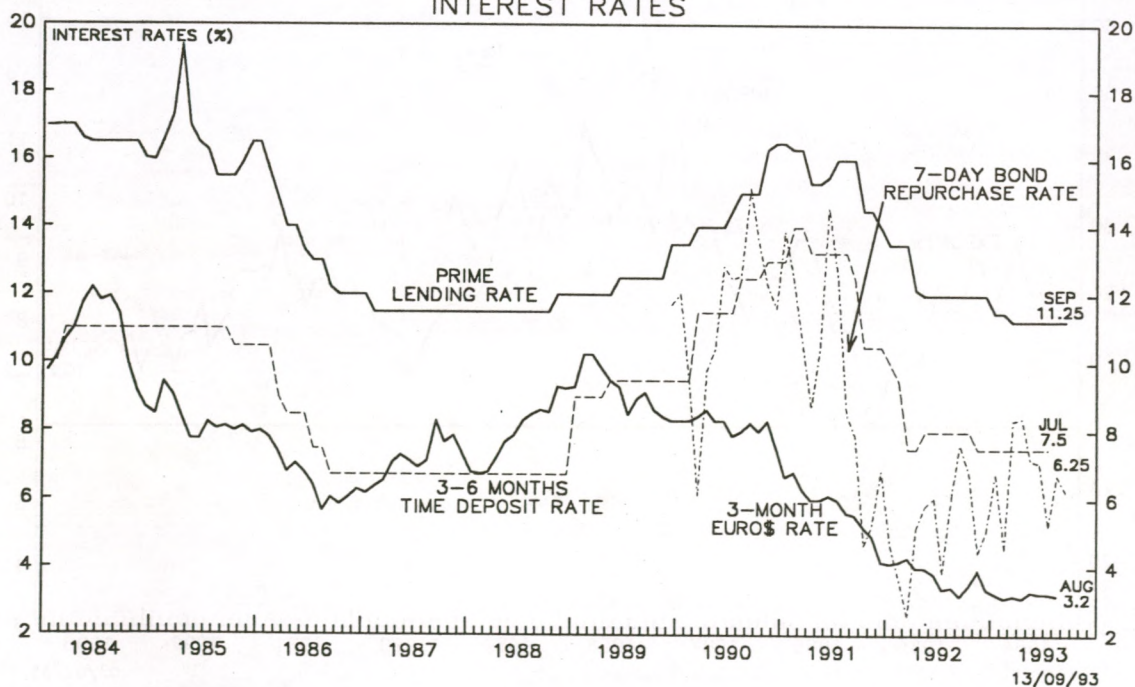


which are easily reversible) and other loans. The other loans category which is the most significant component contains both short and long term offshore net borrowing, although it omits that part of the capital inflows which would be counted under the Bangkok International Banking Facility (BIBF) which opened in March 1993. From Chart 9 the total net inflows do not appear to have reached their maximum until 1991, although they had built up relatively quickly (in 1989) from a meagre trickle in 1988. During 1990-91 they remained strong, but signs of weakness were starting to show in 1992 when total net inflows declined by around 20%. One other notable feature in Chart 9 is the relative stability of FDI flows compared with the other loans category which may be influenced by more cyclical factors.

There are two motives which have acted to draw these higher net capital inflows into Thailand, one of which is externally determined, while the other is determined by internal factors. The external factor concerns the interest differential between Thai rates and foreign interest rates. The fall in international interest rates from 1990 opened the door to higher capital inflows because Thai interest rates were not cut to the same extent. The divergence between Thai lending (or deposit) rates and the 3-month Euro \$ rate from 1989 to 1991 illustrates this (Chart 11). Even after Thai interest rates had started to fall in 1991 the Thai-US\$ differential did not close significantly. This interest differential also contributed to the divergence in the growth of loans and M2 growth after mid 1991 (Chart 1).

The internal factor concerns the degree of domestic financial regulation, and hence Thailand's domestic attractiveness to overseas investors. This will depend heavily on the degree of liberalisation in the capital markets and banking system. There have been three important regulatory changes in the banking and finance sector over the 1987-93 monetary cycle which may affect the longer term inflows of capital. Firstly, in 1990 the BOT

THAILAND: CHART 11
INTEREST RATES



removed a variety of foreign exchange controls which it had previously used on an ad hoc basis. Secondly, a ceiling on general lending rates was removed in 1992 and this has given rise to a plethora of different spreads which the banks charge to different borrowers. In general there has been a rise in the cost of borrowing for small to medium sized firms (the majority of borrowers) compared with a relative fall in the lending rate charged to large (mainly listed) borrowers, who for the most part can easily borrow offshore. However, the minimum lending rate, set by the commercial banks (currently at 11 1/4%) has remained intact. This underlies the high interest rate spreads available to Thai banks. Lastly, a Bangkok International Banking Facility (BIBF) was introduced in March 1993. This involved granting licences to offshore borrowers who were then only liable to pay 10% corporate tax instead of 30%. Effectively the "tax" on offshore borrowing was reduced however, a 10% withholding tax remains in place. The first and third pieces of deregulation clearly involve the removal of obstacles to long term net inward investment, whereas the effects of the second on long term foreign investment depend on whether the (long term) foreign investor would have found it more profitable to borrow from Thai based entities after the removal of the ceiling lending rate. Although most of this financial deregulation has made Thailand a more friendly place to foreign investors a significant proportion of the capital attracted from 1990 onwards is mainly responding to the widened Thai-US interest rate differential.

The 1990-1992 Economic Downturn and the 1993 Recovery

By mid 1990, broad money and credit had reached growth rates of around 30% and 37% yoy respectively (Chart 1). The ensuing downswing over 1990-91 in the monetary cycle was partly externally driven and partly brought about by the BOT's foreign exchange intervention. The downturn in the external demand for Thai exports over 1990-91 led to a widening in the current account and a deterioration in the balance of payments position. The weakening in the Thai Baht that this induced, required the BOT to intervene in the foreign exchange market to support the Thai Baht. This led to a contraction in the growth of the monetary base (Chart 1) and a corresponding rise in both deposit and lending rates in Thailand (Chart 11). Short term lending at the BOT's window also declined at this time. In addition the Bank of Thailand issued its own bonds for a short time over 1990-91 in a further effort to reduce the availability of funds to the banking sector and squeeze their reserves. It succeeded in doing this over 1991 as shown by a 30% fall in excess reserves of all the commercial banks incorporated in Thailand at this time. Slowdowns in credit and broad money growth quickly followed. This monetary slowdown brought down many of the indicators of real economic activity sharply: retail sales growth, industrial production and the BOT's own investment index all declined (Charts 4 and 5) through 1991-92. As one would expect both wholesale and consumer price inflation rates also slowed down over this time. The very low rates of growth in wholesale prices inflation in 1992-93 suggest that there is excess supply and spare capacity in some industrial sectors (Chart 3).

Towards the end of 1991 and the beginning of 1992 as the tight monetary policy was severely reducing real economic activity in Thailand the rate of imports growth slowed and the BOT could then afford to let lending rates come down. In addition the declines in US interest rates throughout 1990-92 enabled Thai lending and deposit interest rates to decline by around 4% over this time without substantially reducing the foreign capital inflows (Chart 11). More recent signs of current account weakness have resulted from the decline in global commodity prices in 1993. These account for just over 20% of total exports. In particular the value of rice exports (28% of agricultural exports) has fallen

over the past year as the price of rice has declined. In addition the growth in exports of manufactured goods (over 70% of exports) appears to have found a floor around 15% yoy.

From mid-1992 onwards, private investment and industrial production have shown a steady recovery. The rates of growth in the production of passenger cars, cement and iron have all been on a consistent upward trend. There is also an acceleration in the rate of capital goods imported which is consistent with these signs of an industrial recovery. The signs of an improvement in consumption demand are less easy to find as many indicators, such as consumer goods imports and auto sales are either declining or have not yet established a trend. Retail sales growth has not started to recover from its precipitous drop in 1991 and continues to grow at an average rate of around 7.5%. The construction sector, often a leading indicator of economic recovery, is benefiting from strong demand for residential property. However, while residential construction permits issued have stepped up over the last 12 months, commercial construction permits issued have fallen indicating relatively low takeup in the commercial property sector.

Evidence supporting the sustainability of this recovery is found by examining the demand for credit. Bills, loans and overdrafts (Chart 1) have remained buoyant growing at around 20% over the last 12-18 months. This follows the central bank loosening in the availability of funds to the banking and financial sector at the end of 1991 and start of 1992. When the shorter term money market rates eased, lending and deposit rates were cut enabling credit growth to stop decelerating and stabilise at around 20%.

Bangkok (the location of most industrial activity) suffers from an overloaded transportation system. This is slowly being dealt with by an expansion in public sector spending on roads and railways. However, a combination of poor administration and difficulties in land acquisition are slowing the transport projects down and this contributes to fiscal underspending and an accumulation of fiscal surpluses. An unplanned fiscal surplus is widely expected by this fiscal year end (October). The 1994 budget, about to be ratified by parliament was set at Baht 625 bn, around 12% higher than that in 1993. If the fiscal surplus in 1993 turns out to continue the downward trend set in 1992, and as a result the government's deposits at the BOT fall, this will represent a loosening of the fiscal drain on the monetary base which Thailand has experienced since the late 1980s. It will enable the banking system to expand the growth of their lending at current interest rates.

SUMMARY & CONCLUSION: Thailand is currently experiencing a recovery in its manufacturing sectors, supported by fairly buoyant credit and M2 growth at current general lending rates (16%). The recent cut in BOT's discount rate from 10% to 9% indicates that further similar falls in lending rates may be possible without significantly weakening the Baht. Lower lending rates bode well for 1994 stockmarket earnings growth. However, while further cuts in lending rates would stimulate a more vigorous recovery, current rates should allow for modest investment growth supporting real GDP growth of around 7-8% over 1993-94. Continued strength in the equity market will be based on the extra "liquidity" from further inflows of foreign capital attracted by relatively strong domestic demand for credit at current lending rates. In addition, the ability of the banks to expand domestic lending at current lending rates would increase if the habitual yearly fiscal surpluses continue to decline over 1993-94. This would permit slightly higher monetary growth.

The recent decline and prospective slow economic growth in the OECD over 1994 (mainly in Japan, EC and the US) implies that the external demand for Thai exports will not be sufficient to induce the kind of double digit real GDP growth experienced in the last monetary upswing which started in 1986-87. Given the BOT's heavily managed exchange rate policy and the (currently) relatively stable current account deficit, the monetary authorities are effectively restrained from making any substantial interest rate cuts. The BOT may nevertheless put pressure on the cartel of banks to reduce their minimum and general lending rates (currently at 11 1/4% and 15-16% respectively) by a token amount. This could be in response to the government's current frustration at what is forecast to be a period of slow growth for Thailand. Notwithstanding this, it is important that the Thai-US interest differential is approximately maintained as the capital inflows it brings will continue to be necessary to counterbalance a persistent deficit on the current account through 1993-94.

AUSTRALIA: FISCAL RESTRAINT IS STILL ILLUSORY

In the current disinflationary environment, where long (10 year) bond yields have fallen to 6.75% and where the overnight rate stands at 4.06%, the domestic economy is only recovering slowly. This is partly due to the slow economic growth in many of Australia's export markets and partly due to the overhang of debt which is still a lingering problem for many firms. In an effort to prevent domestic demand from slowing, while at the same time attempting to rein back public spending, the government announced a slight fiscal expansion in its 1993-94 budget. It contains the following key ingredients:

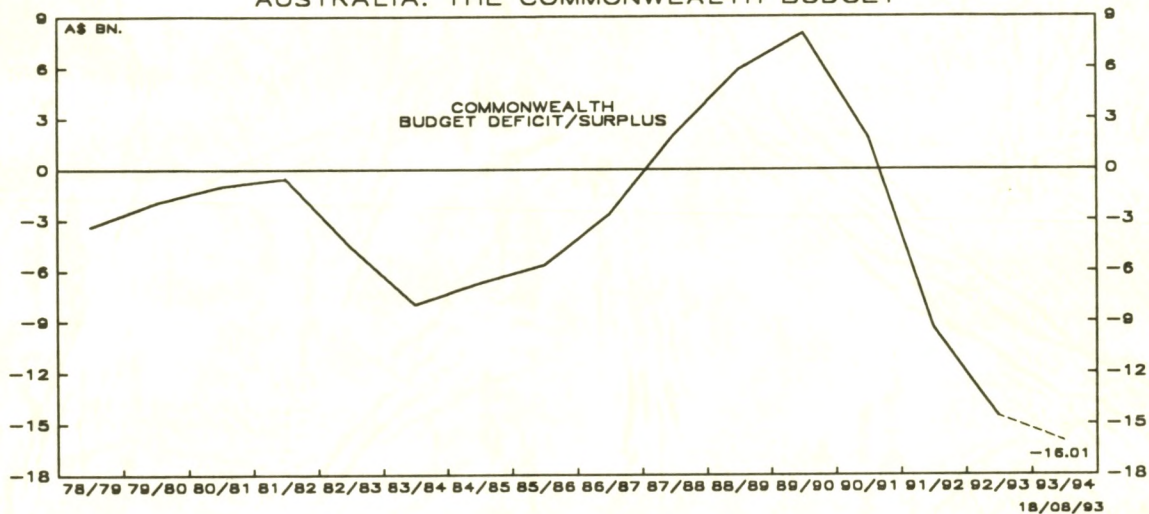
1. The commonwealth budget spending is to increase by around 5% to A\$115.1 bn over 1993-94 (around 30% of GDP). Given the government forecast of 2.75% for real GDP growth over 1993-94, tax revenues are forecast to rise by 4.5% to A\$99.1 bn in the next fiscal year. After some adjustment for asset sales, this will widen the budget deficit to A\$16.0 bn for the next fiscal year.
2. The stated objective to progressively reduce the budget deficit down from A\$16.01 bn (estimated to be 3.8% of 1993-94 GDP) to A\$5.8 bn (estimated at 1% of GDP) by 1996-97.
3. A reduction in the marginal rate of income tax by 3-4% on the middle and upper middle income brackets.
4. Sales tax is to be raised by 1% on all goods that are currently subject to this tax.
5. Excise taxes are to rise on: petrol (by a total of 5 cents per litre over 1993-94), alcohol (by 11% to 31%), tobacco (by 6%) and on luxury automobiles by varying amounts.

Some of the rises in excise duty on specific goods are to take effect gradually over the forthcoming fiscal year. In addition because some of the others have met with strong opposition, it is likely that the final budget will contain a greater number of tax increases to be phased in gradually over 1993-94.

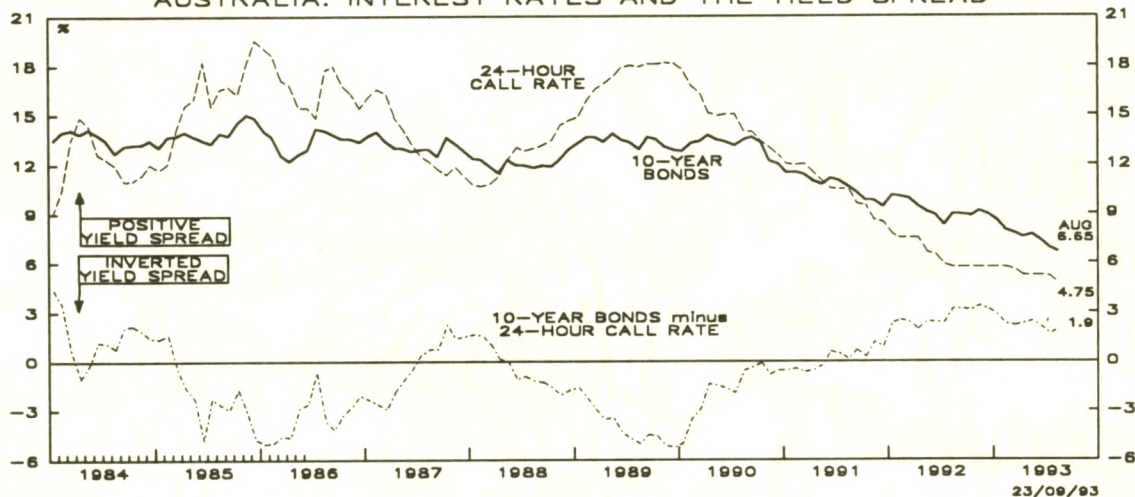
In keeping with one of its ongoing political commitments the Government has reduced the marginal income tax rate for the middle and upper middle income ranges. The implied loss in tax revenue has to some extent been offset by rises in expenditure taxes. There is to be a rise in the sales tax (by 1%) and a number of increases in the excise duty on: petrol, alcohol, tobacco and luxury cars. Because the demand for these latter products is relatively unresponsive to changes in their price the extra excise tax burden will fall mostly on the consumer. By redistributing the source of its tax revenue (from income to expenditure) the Government has been able to achieve its objective in reducing some income tax rates without there being a corresponding rise in the budget deficit. However, significant rises in total tax revenue (and the implied fall in the government deficit) will only occur when GDP begins to grow more rapidly in 1994-95.

The currently depressed state of the Australian economy makes it politically difficult for the current administration to make any cuts in government spending over 1993-94. However, if the Government is to succeed in bringing down the central budget deficit as planned, it will have to make some cutbacks in government spending (starting in 1994). This may mean putting many publically provided services (or parts of them) in private hands. Moreover, there will certainly have to be a substantial cut in Commonwealth and State Government spending as a proportion of GDP (currently around 40%), if the Government is serious about raising the domestic savings rate. This would be necessary because many of the private sector incentives to save are removed when the Government chooses to provide a host of state security benefits.

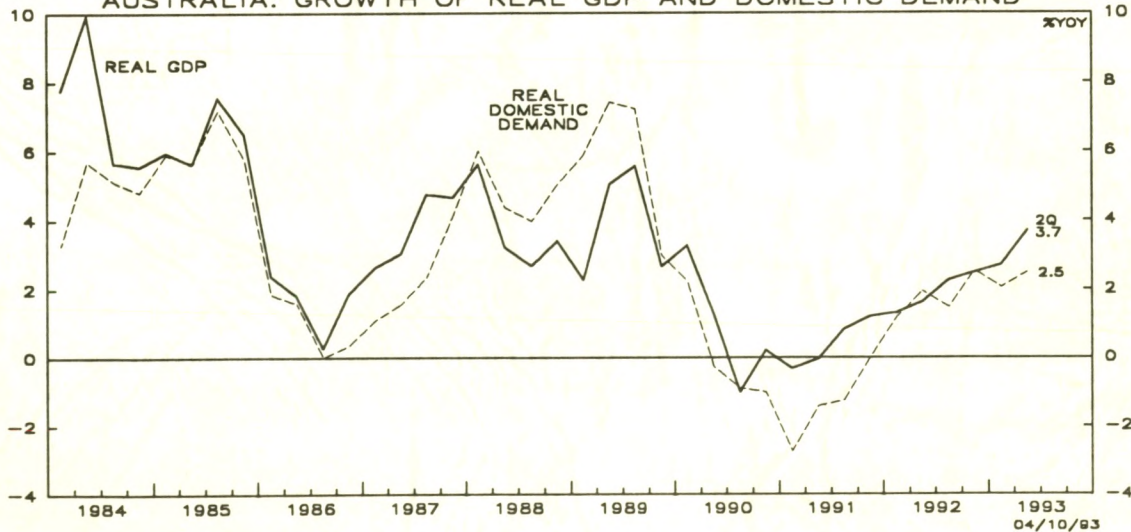
AUSTRALIA: THE COMMONWEALTH BUDGET



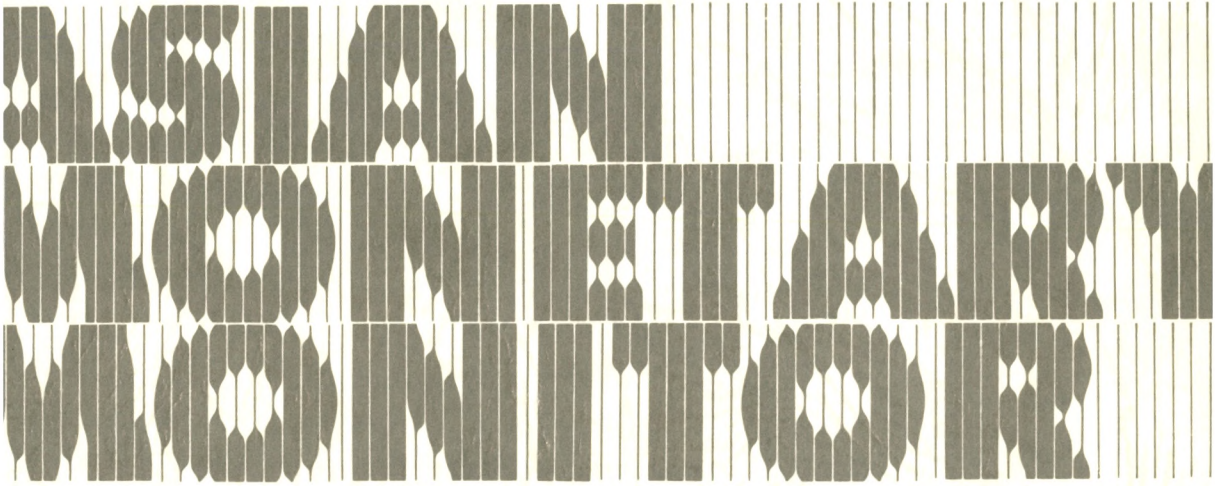
AUSTRALIA: INTEREST RATES AND THE YIELD SPREAD



AUSTRALIA: GROWTH OF REAL GDP AND DOMESTIC DEMAND







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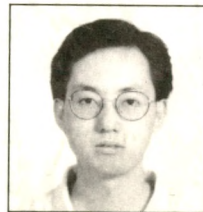
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CHINA HARD LANDING SOON OR HARDER LANDING LATER?

Introduction

China is not different. It may, as some people have recently discovered, have a lot of people; the political stakes may be higher; but it is still subject to the same laws of economics that hold the world over. In this light, the re-emergence of a political agenda in economic policy making in recent weeks is particularly worrying. Deng Xiaoping's assertion that "only speedy development passes the rigorous test of reason" has thrown the continuance of the austerity programme into doubt barely months after it had begun in earnest. Rumours abound that the Patriarch is nearing death, that the succession battle is intensifying, that the provinces are in open rebellion against economic suprema, Zhu Rongji etc. However, whatever the political agenda, it should be obvious that a few months of relatively tight money are not enough to restore macroeconomic balance to the overheated Chinese economy. Moreover, given China's lack of sophisticated economic tools, a soft landing was always going to be elusive. If austerity is truly being relaxed, then a hard landing now will be replaced by a harder landing later. This article is divided into two sections. The first section deals with the current cyclical position, assesses the impact of the austerity programme to date, and offers some forecasts of the direction of China's economy over the next 12-18 months. The second section concerns the various proposed financial system and fiscal reforms to be implemented over the next few years, discusses their feasibility and assess the benefits and dangers associated with success or failure.

Cyclical Developments

In the May-June issue of AMM we indicated that a gentle economic tightening had begun but that much more could be expected over the coming months to bring the overheated Chinese economy back under control. Subsequently, Zhu Rongji has been appointed as governor of the People's Bank of China (PBOC), the central bank (in addition to his position as minister in charge of the economy), and he has implemented his sixteen-point austerity plan (Table 1). At the time of its announcement in July, the austerity plan appeared to be high on rhetoric but low on substance. However, its tone was encouraging nonetheless despite the fact that many of the proposed measures were unspecific and vague. From the point of view of the Chinese leadership, the response of the economy to the plan has been mixed. Certain indicators such as money supply, industrial production and inflation have decelerated in recent months, but others such as the trade deficit and the foreign exchange reserves position have continued to deteriorate. Moreover, the belief that the targeting of just a few economic "hot-spots" would enable the authorities to engineer a soft landing has been somewhat naive. China has only a limited range of unsophisticated macroeconomic tools at its disposal and individuals and companies have amply demonstrated their ability to circumvent selective lending and investment edicts. Hence, the pain

Table 1

BEIJING'S SIXTEEN-POINT AUSTERITY PLAN TO CURB CHINA'S OVER-HEATING ECONOMY - JULY 1993

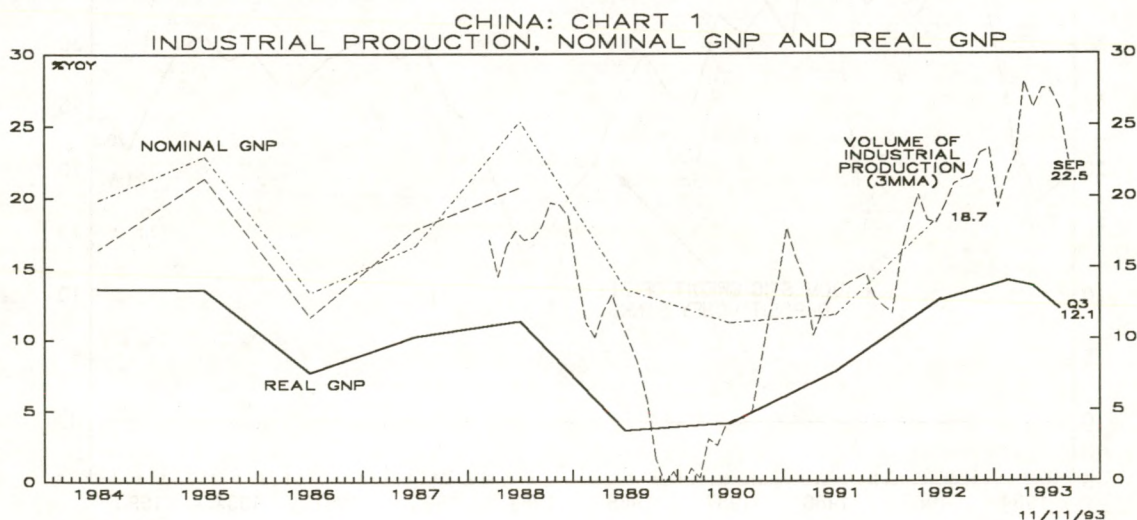
- 1) Call in loans diverted to speculative schemes.
- 2) Force government workers to buy all Government Bonds that have failed to sell within two weeks of issue.
- 3) Raise interest rates.
- 4) Force non-financial institutions to repay funds borrowed from financial institutions.
- 5) Impose a 20% cut in government spending and a ban on any new imports of cars.
- 6) Suspend price reform measures.
- 7) Forbid the issuance of new IOU's to peasants.
- 8) End dubious fund-raising schemes.
- 9) Control real estate fever in development zones.
- 10) Reduce the scale of infrastructure projects.
- 11) Tighter control of companies listing shares on the stockmarket.
- 12) Reform the system for financing exports.
- 13) Force banks to control the way that approve loans.
- 14) Strengthen the Central Bank.
- 15) Clear the transport bottlenecks that keep goods piling up.
- 16) Send out inspection teams to ensure that the provinces obey orders.

has been felt more in the state-owned enterprise (SOE) sector where triangular debt problems have started to re-emerge as a result of reduced credit allocations. A triangular debt occurs when a loss-making SOE cannot afford to pay a supplier which as a result cannot pay a third party. This third party may in turn owe money to the SOE so all payments between companies cease and debts mount up. This often also means that the companies cannot service their bank obligations. Thus the bank cannot extend more credit to allow the SOE to pay the supplier, and so on. The log jam is normally only broken by an injection of central bank credit.

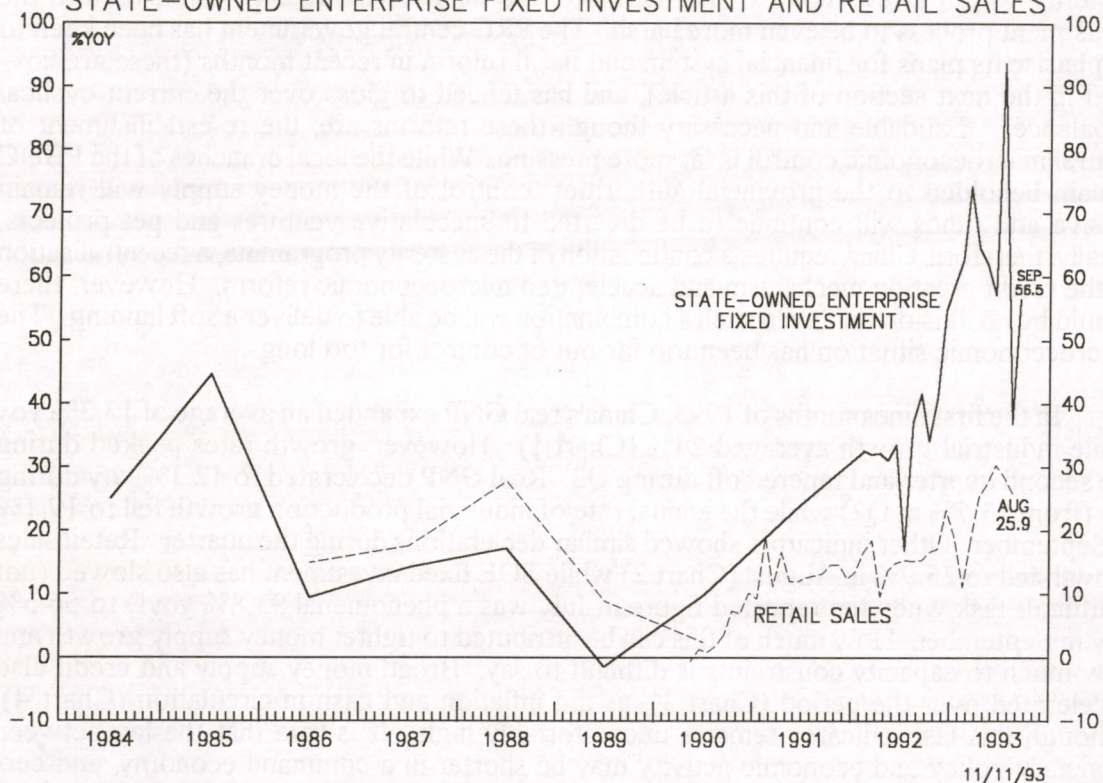
Politics aside, it is the re-emergence of triangular debt that has precipitated the talk of a relaxation in the austerity plan. Should this talk of relaxation be true -- no statistics have been released as yet to confirm or deny any injection of credit -- then the recent

macroeconomic improvements would soon be reversed necessitating a re-imposition of austerity within a few months. Furthermore, the delay in tightening would require the adjustment process to be even more harsh. The PRC central government has been keen to emphasise its plans for financial system and fiscal reform in recent months (these are covered in the next section of this article), and has tended to gloss over the current cyclical imbalances. Laudable and necessary though these reforms are, the re-establishment of central macroeconomic control is far more pressing. While the local branches of the PBOC remain beholden to the provincial authorities, control of the money supply will remain elusive and funds will continue to be diverted to speculative ventures and pet projects. Ideally, therefore, China requires a continuation of the austerity programme, a recentralisation of the credit creation mechanism and accelerated microeconomic reform. However, there should be no illusion that even such a combination will be able to deliver a soft landing. The macroeconomic situation has been too far out of control for too long.

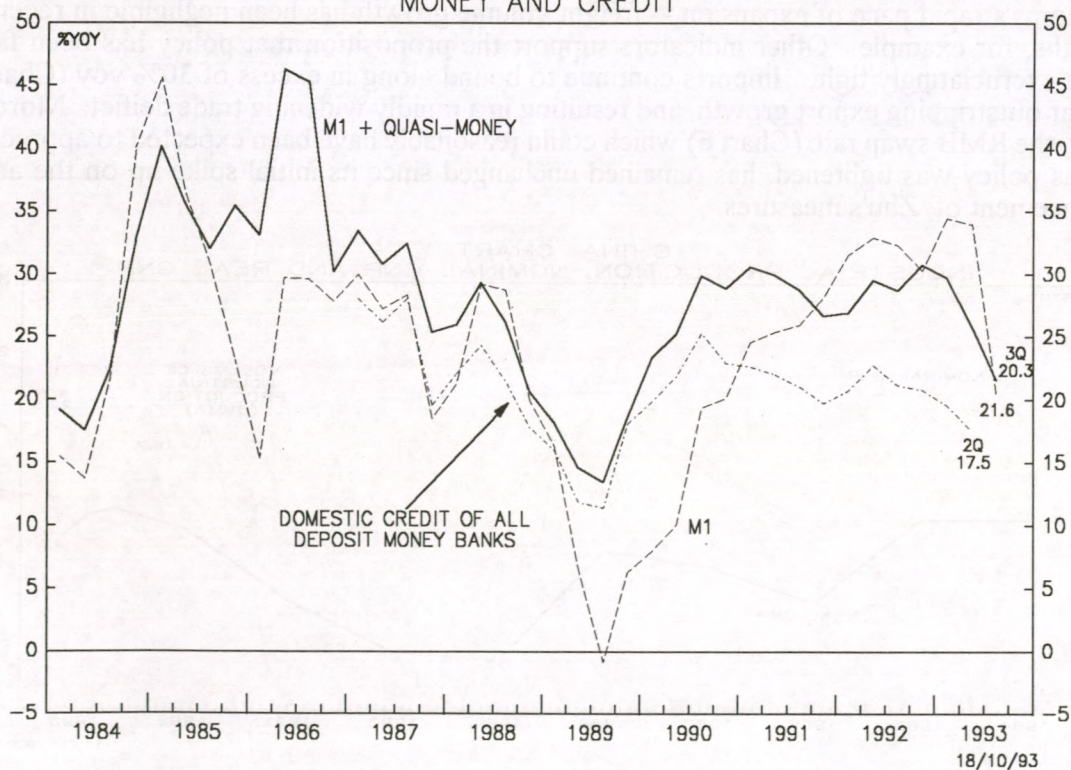
In the first nine months of 1993, China's real GNP expanded an average of 13.3% yoy while industrial growth averaged 24% (Chart 1). However, growth rates peaked during the second quarter and tapered off during Q3. Real GNP decelerated to 12.1% yoy during Q3 (from 13.7% in Q2) while the annual rate of industrial production growth fell to 19.1% in September. Other indicators showed similar decelerations during the quarter. Retail sales growth fell to 25.9% in August (Chart 2) while SOE fixed investment has also slowed (not a difficult task when the reported figure in July was a phenomenal 93.8% yoy!) to 56.5% yoy in September. How much of this can be attributed to tighter money supply growth and how much to capacity constraints is difficult to say. Broad money supply and credit also decelerated over the period (Chart 3), as did inflation and cash in circulation (Chart 4), although this last indicator remains uncomfortably high. It is true that the lag between monetary policy and economic activity may be shorter in a command economy, and certainly tighter credit has hurt some companies, most notably the SOEs. However, anecdotal evidence also suggests that China's infrastructure was already feeling the strain of the economy's rapid pace of expansion -- freight volume growth has been negligible in recent months, for example. Other indicators support the proposition that policy has been far from excruciatingly tight. Imports continue to bound along in excess of 30% yoy (Chart 5), far outstripping export growth, and resulting in a rapidly widening trade deficit. Moreover, the RMB swap rate (Chart 6) which could reasonably have been expected to appreciate as policy was tightened, has remained unchanged since its initial spike up on the announcement of Zhu's measures.



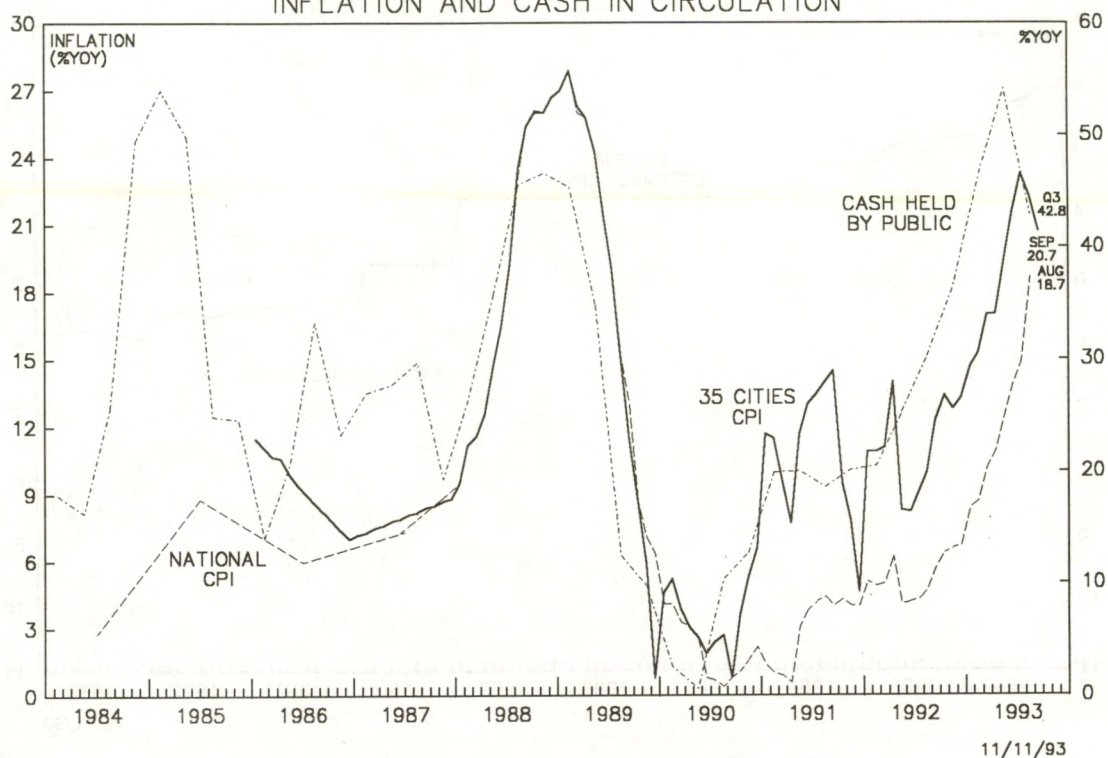
CHINA: CHART 2
STATE-OWNED ENTERPRISE FIXED INVESTMENT AND RETAIL SALES



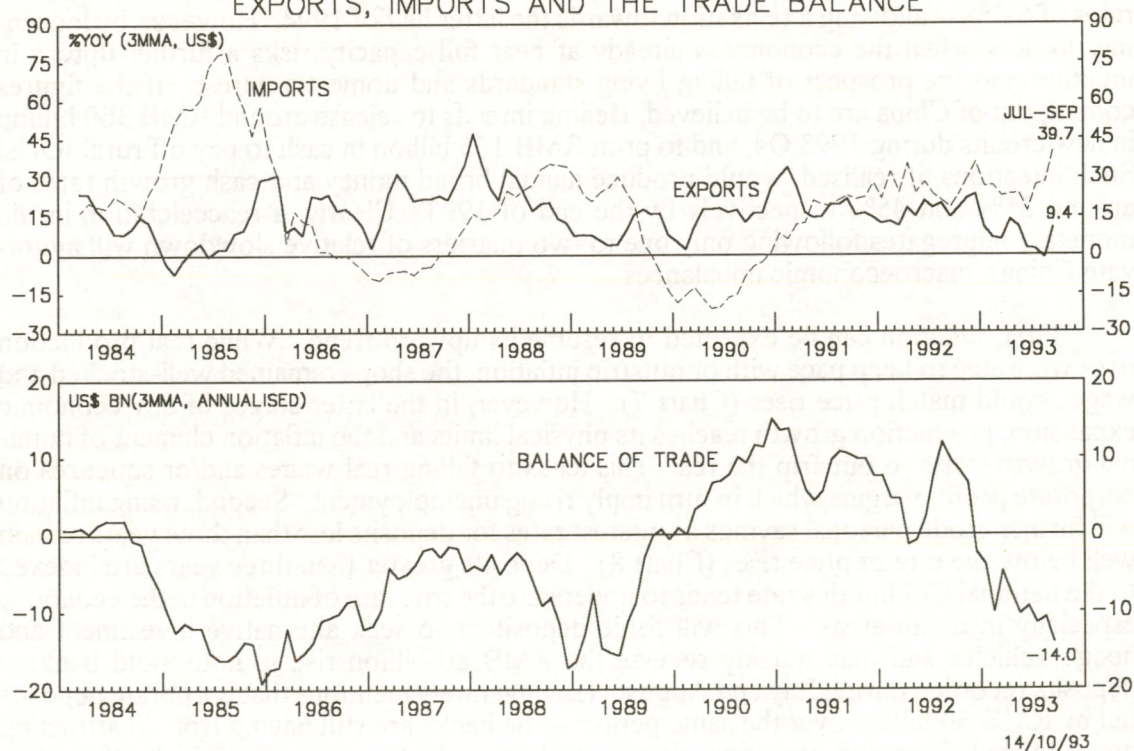
CHINA: CHART 3
MONEY AND CREDIT



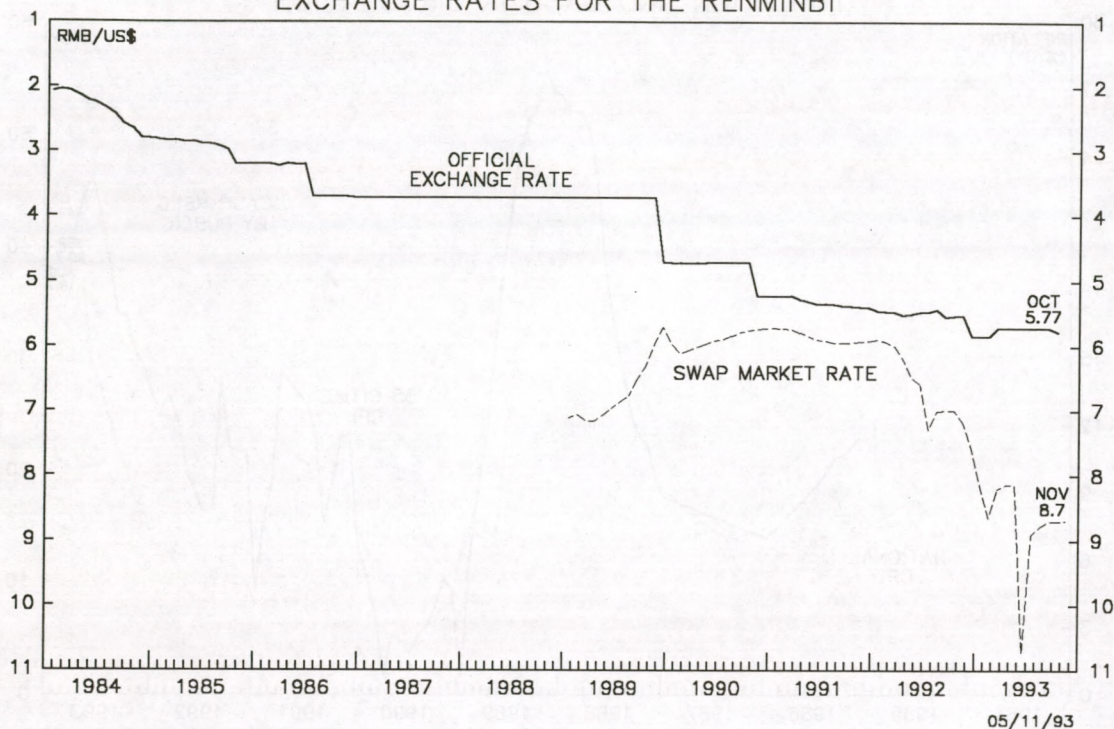
CHINA: CHART 4
INFLATION AND CASH IN CIRCULATION



CHINA: CHART 5
EXPORTS, IMPORTS AND THE TRADE BALANCE



CHINA: CHART 6
EXCHANGE RATES FOR THE RENMINBI



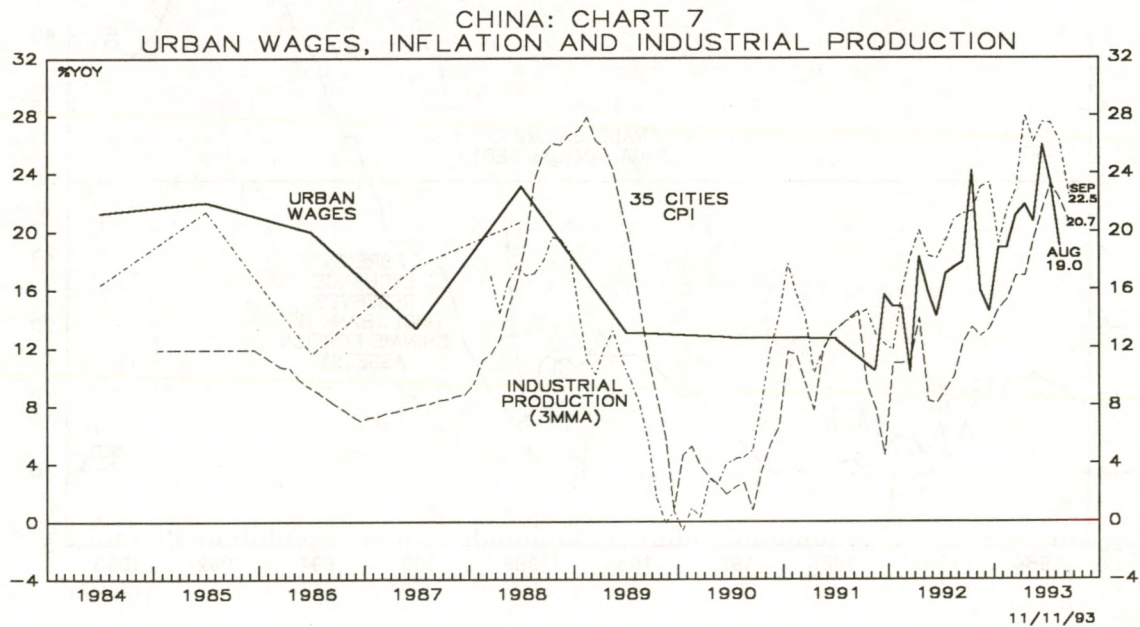
Were the austerity programme to be continued and the provinces forced to obey central directives, the economy could be expected to decelerate further -- to perhaps growth rates of 6-7% -- allowing a relaxation towards the latter half of 1994. However, by loosening up now when the economy is already at near full capacity risks a further upturn in inflation and the prospect of falling living standards and domestic unrest. If the figures coming out of China are to be believed, Beijing intends to release around RMB 360 billion in new credits during 1993 Q4, and to print RMB 105 billion in cash to pay off rural IOUs. Such injections, if realised, would produce annual broad money and cash growth rates of around 25% and 45% respectively by the end of 1993. Clearly, a reacceleration in the monetary aggregates following only one to two quarters of relative slowdown will aggravate China's macroeconomic imbalances.

First, inflation can be expected to resume its upward trend. While real production rises were able to keep pace with or outstrip inflation, the shops remained well-stocked and wages could match price rises (Chart 7). However, in the latter stages of any economic expansion, production growth reaches its physical limits and the inflation element of nominal growth starts to outstrip the real. This leads to falling real wages and/or squeezes on corporate profit margins which in turn imply rising unemployment. Second, rising inflation will further erode personal savings as interest rates for deposits less than three years remain well below the rate of price rises (Chart 8). Deposits greater than three years are indexed to the national CPI but this rate tends to understate the true rate of inflation in the economy, especially in urban areas. This will force depositors to seek alternative investment and hedge vehicles and may quickly reverse the RMB 80 billion rise in household banking deposits recorded during July and August. (Beijing rarely mentions that corporate deposits fell by RMB 60 billion over the same period -- the banks are still having trouble attracting deposits back from non-bank financials, unauthorised bond issues, etc. which offer much

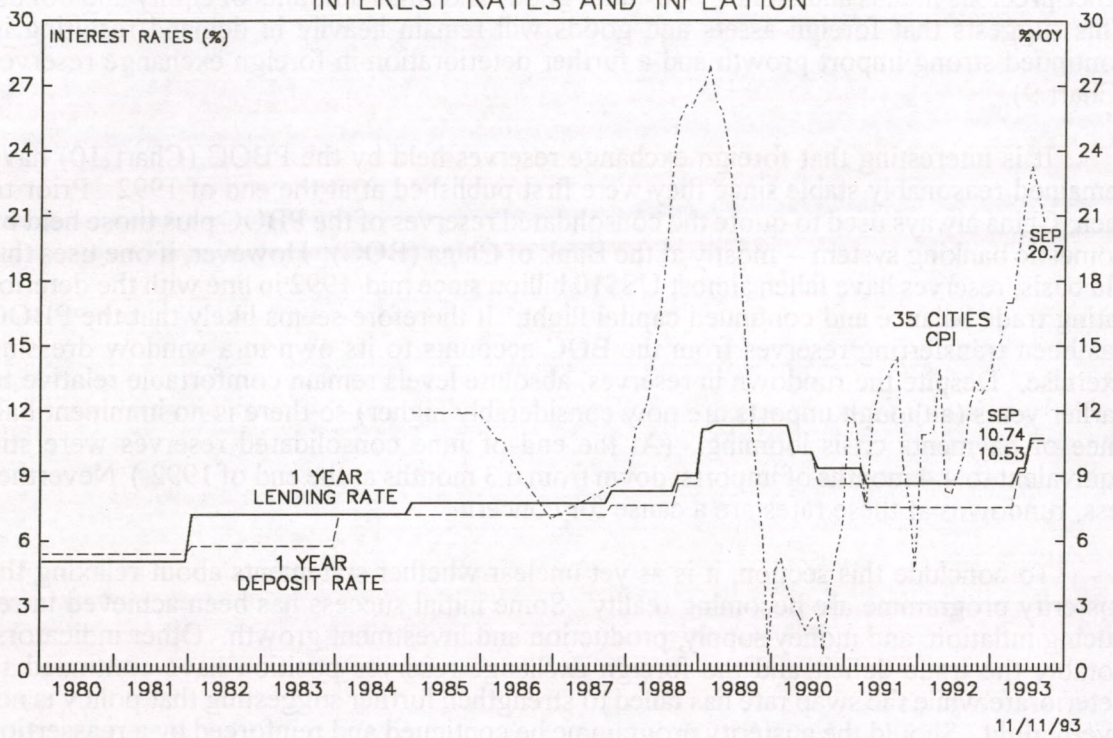
higher interest rates.) Third, the range of alternative vehicles is rather limited -- gold and other precious metals and stones, consumer goods and small amounts of equity and bonds. This suggests that foreign assets and goods will remain heavily in demand resulting in continued strong import growth and a further deterioration in foreign exchange reserves (Chart 9).

It is interesting that foreign exchange reserves held by the PBOC (Chart 10) have remained reasonably stable since they were first published at the end of 1992. Prior to then, China always used to quote the consolidated reserves of the PBOC plus those held by domestic banking system -- mostly at the Bank of China (BOC). However, if one uses this old basis, reserves have fallen almost US\$10 billion since mid-1992 in line with the deteriorating trade balance and continued capital flight. It therefore seems likely that the PBOC has been transferring reserves from the BOC accounts to its own in a window dressing exercise. Despite the rundown in reserves, absolute levels remain comfortable relative to earlier years (although imports are now considerably higher) so there is no imminent balance of payments crisis looming. (At the end of June consolidated reserves were still equivalent to 4.4 months of imports, down from 6.3 months at the end of 1992.) Nevertheless, rundowns at these rates are a cause for concern.

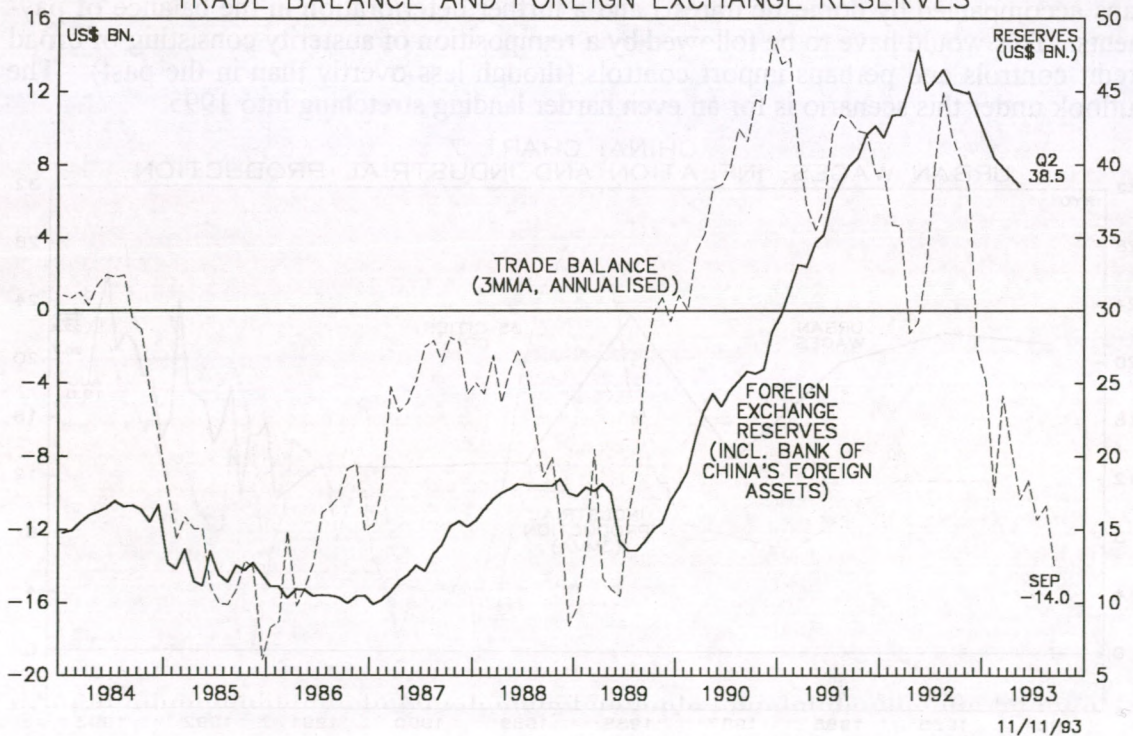
To conclude this section, it is as yet unclear whether statements about relaxing the austerity programme are becoming reality. Some initial success has been achieved in reducing inflation, and money supply, production and investment growth. Other indicators, notably the trade deficit and the foreign exchange reserves position have continued to deteriorate while the swap rate has failed to strengthen further suggesting that policy is not overly tight. Should the austerity programme be continued and reinforced by a reassertion of central control over the provinces, China could reasonably expect a slowdown in growth to 6-7% during the first half of 1994, and a return to higher growth in early 1995. Relaxation of austerity at this stage risks a resurgence in inflation, falling living standards (perhaps accompanied by domestic unrest) and a further deterioration in the balance of payments. This would have to be followed by a reimposition of austerity consisting of broad credit controls and perhaps import controls (though less overtly than in the past). The outlook under this scenario is for an even harder landing stretching into 1995.



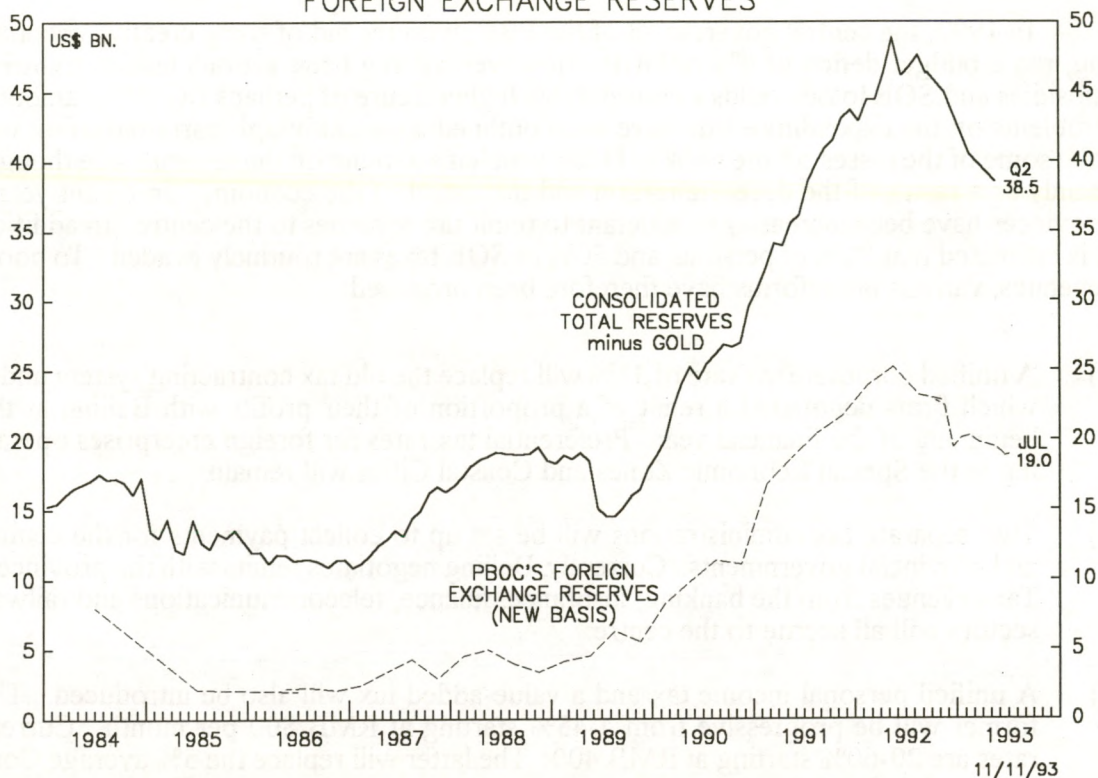
CHINA: CHART 8
INTEREST RATES AND INFLATION



CHINA: CHART 9
TRADE BALANCE AND FOREIGN EXCHANGE RESERVES



CHINA: CHART 10
FOREIGN EXCHANGE RESERVES



Economic Reform

The recent 3rd Plenum of the 14th Central Committee of the Chinese Communist Party has approved a wide range of economic reforms designed "to ensure sustainable and rapid economic development into the next century". Among the ambitious blueprints presented to the Plenum were proposals to reform the tax system, the financial system and the foreign exchange markets. (Highlights from the proposals put forward by the Plenum are outlined in an Appendix at the end of this article.) Some of these reforms have a fair chance of succeeding; others however, are mere pipedreams in the absence of a reining in the provinces, and a radical restructuring of the root of many of China's problems -- the SOEs.

SOE reform is in fact on the agenda, but this involves the corporatisation of companies and the allowance of takeovers and mergers. While this may be appropriate for the smaller and (relatively) more efficient SOEs, it is difficult to see how the huge loss-making behemoths will benefit. Little has been proposed in the way of allowing these firms to fail, or of paring back their immense overstaffing levels. Thus the SOE's role as a welfare service will remain and in turn banks and the central government will be obliged to fund this service. Budget deficits, subsidised credit and non-performing loans will continue to be the offshoot. SOE reform aside though, microeconomic reform in other sectors is to be welcomed as are any further reductions in the role of the state in the economy.

1) Fiscal Reform

In 1992, the central government of the PRC, with the aid of some creative accounting, ran a budget deficit of 4% of GDP. However, adding back various hidden transfers subsidies and SOE losses yields a considerably higher figure of perhaps twice this amount. Problems on the expenditure side have been outlined above although corporatisation will take some of the losses off the books. Other problems abound on the revenue side though, mainly as a result of the decentralisation and decontrol of the economy. In recent years, provinces have been increasingly reluctant to remit tax revenues to the centre. In addition it is estimated that 90% of personal and 50% of SOE taxes are routinely evaded. To boost revenues, various tax reforms have therefore been proposed:

- a) A unified corporate tax rate of 33% will replace the old tax contracting system under which firms negotiated a remit of a proportion of their profits with Beijing at the beginning of the financial year. Preferential tax rates for foreign enterprises operating in the Special Economic Zones and Coastal Cities will remain.
- b) Two separate tax administrations will be set up to collect payments for the central and provincial governments. Currently, Beijing negotiates remits with the provinces. Tax revenues from the banking, insurance, finance, telecommunications and railway sectors will all accrue to the centre.
- c) A unified personal income tax and a value-added tax will also be introduced. The former will be progressive from 4-45% starting at RMB 800 per month. Current rates are 20-60% starting at RMB 400. The latter will replace the 5% average Consolidated Industrial and Commercial Tax. No new rate has been announced.

Beijing has two targets for these reforms. The tax to GDP ratio should rise to 25% within 5 years (currently 17%) while the share of central government in total tax revenues is expected to increase from 22% to 60% over the same period. Success will depend on incentivising collectors, reducing the opportunities for corruption and evasion, and reining in the provinces. None of these will be easy.

2) Financial Sector Reform

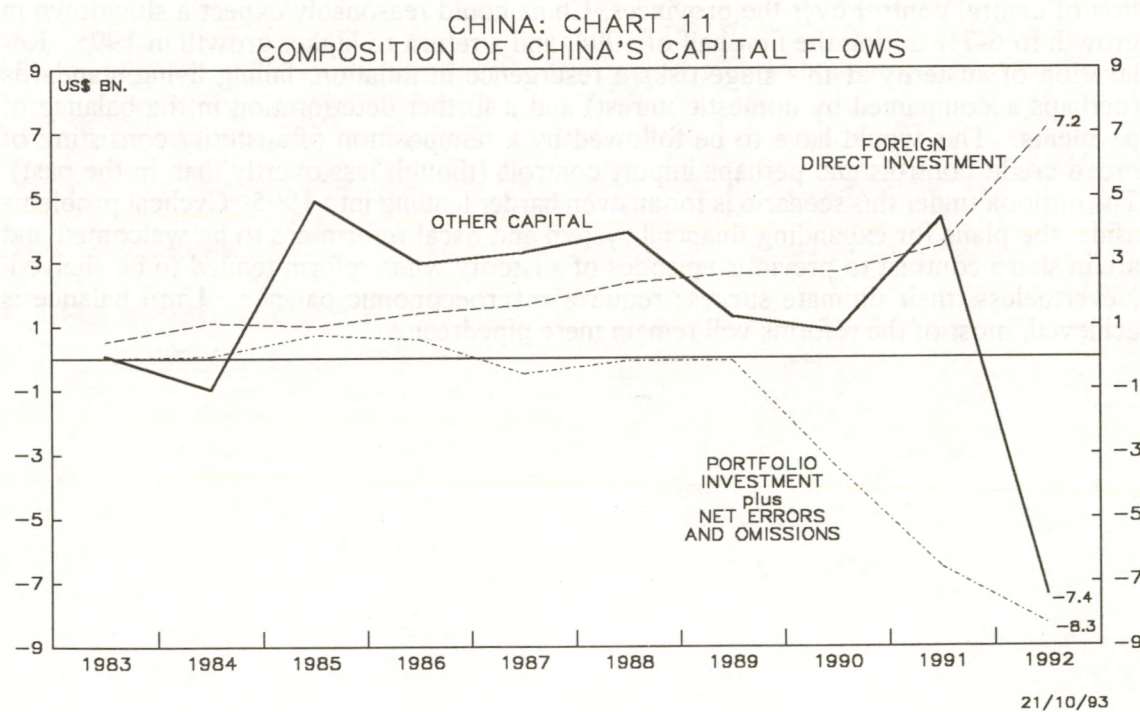
- a) The PBOC will become a Western-style central bank charged with "maintaining the value of the currency" and supervising the banking system.
- b) The authority of local branches of the PBOC to extend credit within their own provinces will be curtailed.
- c) Three new state banks will be set up -- The State Long Term Development Trust Bank, the Import and Export Credit Bank and the Agricultural Policy Bank -- with the sole responsibility of extending policy loans. Other banks will move towards becoming commercial lenders.

The key here again is to bring the provinces into line. Allowing banks to lend on a commercial basis is commendable but will also require unified, market-determined interest rates. Meanwhile, policy loans will be concentrated on only three balance sheets but these will still have to be supported by government finance. How independent the new PBOC will be in this area remains to be seen.

3) Foreign Exchange Reform

- a) The foreign exchange quota retention scheme for exports is to be ended.
- b) The official exchange rate will be abolished (as at January 1st 1994), Foreign Exchange Certificates will be phased out and all swap centres will be linked by a computer network. Full currency convertibility within 5 years is the ultimate aim.
- c) Overseas investments and use of foreign exchange revenues from exports will be more closely controlled to reduce capital flight.

Unifying the currency and making it convertible requires a range of steps to be taken. The current swap market is in effect a number of segmented currency markets with no real opportunity for arbitrage between different centres. Establishing a single market swap rate is therefore essential. Although computerisation will help, unification of the different swap rates will also require a unified, efficient domestic money market. A further complicating factor is that abolition of the official rate at this stage will hurt most the SOEs and other government-related establishments that access foreign exchange at this preferential rate -- foreign exchange is about 50% more expensive at the swap rate than at the official rate. Unless the central government is prepared to make additional large-scale fiscal transfers to compensate for this loss of cheap foreign exchange, unification of the



currency will put the SOEs' already precarious finances under further pressure. The withdrawal of this effective subsidy could also have inflationary implications if the SOEs are able to pass on the rise in their import costs. Although the removal of market distortions is always welcome, unification would have made more sense had the gap between the official and swap rates been narrower. This in turn would only have occurred had monetary conditions been tightened sufficiently to re-establish confidence in the domestic currency and to bring about an appreciation in the swap rate. With policy apparently being relaxed again, the next move in the currency (at least on the black markets) will probably be down.

Given these pre-requisites it seems highly unlikely that a convertible currency for current account transactions will be established until 1995 at the earliest. Moreover, establishment of full capital account convertibility is still many years away. China has recently announced that inward foreign investment will reach US\$100 billion this year. There is no doubt that investment inflows have been huge over the years but the figures considerably overstate the true picture. China includes both investment approvals and loans in its quoted investment figures. However, on a balance of payments basis, (net) foreign direct investment registered only US\$7.2 billion in 1992 (Chart 11). Furthermore, strong as loan inflows have been, they have been more than matched by Chinese banks lending overseas, outward portfolio investment plus capital flight. Net lending or other capital registered a US\$7.4 billion outflow in 1992 while net portfolio investment and capital flight hit US\$8.3 billion. It seems that as fast as the foreigners pour money in to China, the Chinese take it out again. The only way to stem this outflow is to re-establish macroeconomic control, restore confidence in the domestic currency and offer a wide range of attractive domestic assets and investment opportunities.

CONCLUSION: Statements in recent weeks suggest that China has started to relax its austerity plan after only a few months. As yet it is unclear whether such statements are becoming reality and for the moment the economy is showing some signs of coming back under control. Should the austerity programme be continued and reinforced by a reassertion of central control over the provinces, China could reasonably expect a slowdown in growth to 6-7% during the first half of 1994, and a return to higher growth in 1995. Relaxation of austerity at this stage risks a resurgence in inflation, falling living standards (perhaps accompanied by domestic unrest) and a further deterioration in the balance of payments. This would have to be followed by a reimposition of austerity consisting of broad credit controls and perhaps import controls (though less overtly than in the past). The outlook under this scenario is for an even harder landing into 1995. Cyclical problems aside, the plans for expanding financial system and fiscal reform are to be welcomed and are in sharp contrast to previous episodes of austerity when reform tended to be shelved. Nevertheless, their ultimate success requires macroeconomic balance. Until balance is achieved, most of the reforms will remain mere pipedreams.

APPENDIX

Decision of the CPC Central Committee on issues concerning the establishment of a socialist market economic structure (some highlights)

In order to fulfill the task of reforming the economic structure put forward at the 14th National Congress of the Chinese Communist Party and to accelerate reform, opening to the outside world and the socialist modernisation drive, the Third Plenary Session of the 14th Central Committee of the Communist Party of China has discussed some major issues concerning the establishment of a socialist market economic structure, and has adopted the following decision.

I. The New Situation and New Tasks in China's Efforts to Reform Its Economic Structure

Great changes have occurred in China's economic structure through reforms over the past dozen years guided by the theory of building socialism with Chinese characteristics put forward by Comrade Deng Xiaoping.

The 14th National Congress explicitly laid down the task of establishing a socialist market economic structure, which is an important component of the theory of building socialism with Chinese characteristics and is of profound and far-reaching significance for China's modernisation drive. To establish a new economic structure by the end of this century is a great historic task of the whole Party and people of all nationalities in China during the new period.

The socialist market economic structure is linked with the basic system of socialism. The establishment of this structure aims at enabling the market to play the fundamental role in resource allocations under macro-economic control by the State.

To turn this goal into reality, it is necessary to uphold the principle of taking the publicly owned sector as the mainstay, while striving for a simultaneous development of all economic sectors, to further transform the management mechanism of State-owned enterprises, and to establish a modern enterprise system which meets the requirements of the market economy and in which the property rights as well as the rights and responsibilities of enterprises are clearly defined, government administration and enterprise management are separated and scientific management is established.

It is necessary to establish a nationwide integrated and open market system to closely combine the urban market with the rural market and link the domestic market with the international market, so as to optimise the allocation of resources.

It is necessary to transform the government's functions in economic management and establish a sound macro-economic control system in which indirect means form the mainstay so as to ensure the healthy operation of the national economy.

It is necessary to establish an income distribution system which takes the principle of "to each according to his work" as its mainstay, gives priority to efficiency while taking fairness into account so as to encourage some localities and people to become prosperous first while adhering to the road to common prosperity.

It is also necessary to establish a multi-layered social security system and provide both urban and rural people with a degree of security commensurate to China's reality so as to promote economic development and social stability.

All these major links comprise an organic entity, inter-related and mutually conditioning, together forming the basic framework of the socialist market economy.

It is necessary to establish a legal system in line with and corresponding to these major links, and to adopt down-to-earth measures to push the overall reform forward actively step by step and promote the development of the social productive forces.

It is necessary to change the traditional concepts of planned economy and advocate active exploration and bold experiment. Therefore, it is necessary, on the one hand, to inherit our fine traditions and, on the other, to break away from outmoded convention and, proceeding from the realities of China, learn from those experiences of all countries, including the developed capitalist countries, that reflect the general laws of social production and market economy.

II. Changing the Operation Mechanism of State-owned Enterprises and Establishing a Modern Enterprise System

A modern enterprise system with public ownership as its mainstay is the foundation of the socialist market economic structure.

To continuously deepen enterprise reform, it is necessary to tackle some deep-seated contradictions, focus on innovations of the enterprise system, further emancipate and develop the productive forces and bring the superiority of the socialist system into full play.

Establishing a modern enterprise system is a necessary requisite for developing socialised mass production and the market economy; and it represents the orientation of reform of China's State-owned enterprises.

Its basic features are: First, the property rights relationships are clearly defined; the ownership of State-owned assets in the enterprises belongs to the State; the enterprises, as legal entities, possess all rights over the assets formulated by investments from various sources, including the State, and become legal entities that enjoy rights and shoulder responsibilities under civil law.

Second, the enterprises use all the resources to which legal entities are entitled to conduct management independently and shoulder sole responsibility for gains and losses according to law, pay taxes in line with related stipulations, and assume the responsibility of maintaining and increasing the value of the assets in the interests of the investors.

Third, the investors enjoy, commensurate with their shares of capital investment, their rights and interests as part owners of the enterprises, that is, the right of dividend and the right to take part in strategic decisions and choice of managers. Should the enterprises go bankrupt, the investors only shoulder limited liability for the debts of such enterprises according to the amount of their capital investment.

Fourth, the enterprises organise production and management according to market demand and aim at raising the productivity of labour and the economic returns of the enterprises. The government does not directly interfere with the managerial activities of the enterprises. Those which have been in losses for a long time and whose assets cannot cover the debts should apply for bankruptcy according to law; the successful enterprises prosper and those which fail are eliminated in the market competition.

Fifth, it is necessary to establish a scientific enterprise leadership structure and organisational management system, regulate the relations between the owners, managers, the workers and staff, and build a management mechanism which combines incentives and restraints. All enterprises should work hard toward this direction.

In key enterprises in "backbone" and basic industries, the State should have controlling shares and at the same time bring in non-State capital, so as to expand the leading role and scope of influence of the State sector of the economy.

III. Cultivating and Expanding the Market System

Giving effect to the basic role of the market mechanism in the allocation of resources requires the cultivation and expansion of the market system.

Currently, the emphasis should be on developing the production-factors market, standardising market activities, breaking the barriers and blockades between regions or departments, opposing unfair competition and creating an environment for competition on equal terms, so as to form a unified, open, competitive and orderly integrated market.

Pushing forward price reform and establishing a mechanism in which the prices are formed mainly by the market.

Reforming the existing commodity circulation system and further developing the commodity market. Wholesale markets will be set up for bulk agricultural produce, industrially produced consumer goods and capital goods in major commodity-producing, marketing and distributing areas.

The present cultivation of the market system should focus on the development of markets for finance, labour, real estate, technology and information.

Developing and perfecting the financial market focused on bank loans. Capital markets should actively but steadily expand financing activities in the form of bonds and stocks.

It is necessary to establish a rating system for bond-issuing agencies and bond credits, so as to bring about the healthy development of the bond market.

It is necessary to standardise and gradually expand the scale of the issue and listing of stocks.

The money market should develop standard inter-bank lending and bill discount; the central bank should develop trading in government bonds. Illegal raising of funds, money-lending and other such financing activities should be resolutely checked and corrected.

Reforming the labour system and gradually forming a labour market. China's abundant labour force is advantageous for economic development, but also brings pressure on employment.

The development, utilisation and rational allocation of human resources should be the starting point of developing the labour market. We should create more job opportunities in order to employ more urban labour forces. We should encourage and guide the surplus rural labour force to shift gradually to non-agricultural fields, and effect orderly labour mobility between regions. We should develop various forms of employment, and use economic measures to adjust the employment structure, so as to form an employment mechanism for the two-way choice between the employing units and the employees and rational labour mobility.

Standardising and developing the real estate market. With scarcity of land and a large population, we in China have to value and make rational use of land resources, and strengthen land management. We should conscientiously protect cultivated land and strictly control the transfer of land from agricultural to non-agricultural use.

The State monopolises the primary urban land market. We should implement a system for the transfer of land-use rights with compensation and within a time limit. With regard to the sale of land-use rights for commercial purposes, we should change the method of negotiated lease into one of public bidding and auctioning.

At the same time, we should strengthen the management of secondary markets and establish a normal market mechanism for the formation of prices for land-use rights. By starting to levy and adjust real estate taxes and other fees, we should forestall any attempt to reap excessive profits in real estate transactions and prevent the loss of State profits.

We should control the rapid growth of luxury housing and high-consumption recreational facilities. We should accelerate reform of the urban housing system, control the land price for housing and promote the commercialisation of housing and the development of housing construction.

Further developing the technological and information markets. We should introduce a mechanism of competition in these spheres, protect intellectual property rights, carry on transfers of technological achievements with compensation and promote commercialisation and industrialisation of technological research results and information.

IV. Transforming Government Functions, Establishing a Sound Macro-economic Control System

The establishment of a socialist market economy urgently requires the transformation of government functions and reform of government organisations.

Government functions in economic management consist mainly of devising and implementing macro-economic control policies, appropriate construction of infrastructure facilities and creation of a favourable environment for economic development.

The government manages the national economy by economic, legal and necessary administrative means, but it does not directly interfere in the production and management of enterprises.

At present, over-staffing, overlapping of functions and inefficient organisation, prevalent at all levels of government, are seriously retarding the process of transforming the operational mechanism of enterprises and the establishment of a new structure. In line with the principles of separating the functions of the government from those of enterprises, simplifying structures and promoting unity and efficiency, we should continue to reform government organisations and seek to complete this task at the earliest possible date.

The socialist market economy must have a sound macro-economic control system.

The main tasks of macro-economic control are: to maintain a basic balance between total supply and total demand in the economy, promote the optimisation of the economic structure, guide the national economy in sustained, rapid and healthy development and bring about all-round social progress. In macro-economic control, we should primarily use economic measures; we should, in the near future, take significant steps in the reform of the systems of taxation, financing, investment and planning, and establish a mechanism in which planning, banking and public finance are co-ordinated and mutually check each other while strengthening the overall co-ordination of economic operations.

Actively pressing ahead the reform of the fiscal and taxation systems. Reform in the near future should focus on: First, changing from the current fiscal contractual responsibility system of local authorities to a tax assignment system on the basis of a rational division of power between central and local authorities, and establishing separated central and local taxation systems

The categories of taxes required for safe-guarding national rights and interests and the exercise of macro-economic control are assigned as the central tax; the main categories of taxes directly related to economic development are assigned as the sharing taxes; the range of items subject to local tax should be broadened to increase local revenue.

Through developing the economy, improving efficiency and opening up more sources of revenue, we should gradually increase the percentage of fiscal income in the gross national product (GNP) and rationally determine the proportion between central and local fiscal income. We should implement a system where in the central fiscal authority returns and transfers payments to local authorities in order to adjust the distribution pattern and regional structure, and in particular to support the development of economically underdeveloped regions and the transformation of the old industrial bases.

Second, it is necessary to reform and improve the taxation system in line with the principles of unifying tax laws, fairness of tax burden, simplification of the tax system and rational division of power. We should implement an indirect tax system based mainly on the value-added tax, levy consumption taxes on a small number of goods and continue to levy the turnover tax on most non-product businesses.

On the basis of reducing the rate of the income tax imposed on State-owned enterprises, and of discontinuing construction funds for key energy and communications projects and budgetary regulatory funds, enterprises should pay taxes according to law, and the ratio of profit distribution between the State and State-owned enterprises can be straightened out.

We should introduce uniformity in enterprise income tax and personal income tax, standardise tax rates and expand the tax base. We should levy and readjust taxes of certain categories, check up on tax reductions and exemptions, strictly enforce the levying and management of taxes and block the loss of tax income.

Third, we should improve and standardise the double budget system. We can set up a government public budget and a budget for management of State assets and, when necessary, establish a social security budget and other budgets.

We should strictly control fiscal deficits. The fiscal deficits of the central authorities should be met by issuing long-and short-term government bonds rather than by overdrafts from the bank. The government's domestic and external debts should be centrally managed.

Accelerating reform of the financial system. As the central bank, the People's Bank of China, under the leadership of the State Council, should implement monetary policies independently. It should control the money supply and stabilise currency value by changing from relying mainly on the control over the scale of credit to using such means as reserve ratio on deposits, the central bank's lending rates and open market operations; it should supervise over and control various types of financial institutions and maintain the financial order, and no longer handle businesses with non-financial institutions.

Banking business and securities business should be managed along separate lines. A monetary policy committee should be organised for the timely adjustment of monetary and credit policies. To meet the needs of the nationwide circulation of money and the requirements of centralised and unified regulations, the branches of the People's Bank of China are clarified as agencies of its head office, and active efforts should be made to create conditions for setting up trans-regional branches.

We should establish policy-lending banks, and should separate policy-lending banking from commercial banking. We should organise the National Development Bank and the Import and Export Credit Bank, and reorganise the Agricultural Bank of China, all of them handling strictly defined policy-related business.

We should develop commercial banks. Existing specialised banks should gradually change into commercial banks and, when necessary, rural and urban co-operative banks should be set up step by step. The commercial banks should engage in the management of the proportions of assets and liabilities and in management of risks. We should standardise and develop non-banking financial institutions.

In light of the changes in the monetary supply and demand, the central bank should make timely readjustments of the benchmark interest rate and allow the deposit and loan interest rates and commercial banks to float freely within a specified range.

We should reform the foreign exchange control system, set up a market-based manageable floating exchange rate system, and set up an integrated and standardised foreign exchange market. Renminbi yuan should gradually become a convertible currency.

We should set up computer networks for the banking system, expand the use of such payment instruments as commercial bills of exchange and checks, enforce strict settlement discipline, improve settlement efficiency, and actively popularise the use of credit cards so as to reduce the amount of cash in circulation.

V. Establishing Rational System of Income Distribution to Individuals and Social Security

In the distribution of incomes to individuals, it is necessary to adhere to the system which takes the principle of "to each according to his work" as its mainstay and facilitates the coexistence of multiple distribution methods, and to implement the principle of giving priority to efficiency while taking fairness into account.

It is necessary to introduce competitive mechanisms for rewarding individual labour and break away from egalitarianism, so as to implement the principle of more pay for more work and rationally widen the income gap. The policy of encouraging some localities and people to become prosperous first through honest labour and legal operation should be adhered to, and those who have become well-off should be encouraged to lead forward and support those lagging behind, so as to achieve common prosperity step by step.

VI. Deepening Rural Economic Structural Reform

Agriculture, rural areas and the farmers are fundamental issues concerning China's economic development and modernisation drive.

The reform in China's rural areas over the past decade and more has brought historic changes to the socio-economic outlook of rural areas, and laid a foundation for the reform and development of the entire national economy. In recent years, the rural areas have been facing new problems which call for immediate solution, the chief ones being the decline of the comparative returns of agriculture, particularly grain and cotton production, the widening of the scissors gap between the prices of industrial and agricultural products, and the slow growth of the incomes of farmers.

We should stabilise the Party's basic policies in the rural areas, deepen rural reform, expedite rural economic growth, increase the incomes of farmers, and further strengthen the role of agriculture as the foundation of the national economy, so as to ensure that agricultural production will reach a new height by the end of this century and the living standards of the masses of farmers shall be raised from the current level of sufficient food and clothing to a better-off level of moderate prosperity.

VII. Deepening the Reform of the System of Foreign Economic Relations, Opening Wider to the Outside World

Firmly carrying out the policy of opening to the outside world, expediting the opening-up effort, making full use of the international and domestic markets and resources both at home and abroad, and optimising the allocation of resources. We should actively participate in international competition and economic-operation, give play to the comparative advantages of our economy, develop an open economy, and allow the domestic economy to dovetail with and supplement the international economy. We should standardise our foreign economic activities in line with our national conditions and the norms of international economic life, correctly handle our foreign economic relations, and constantly increase our competitiveness in international markets.

VIII. Further Revamping Scientific, Technological and Educational Systems

Science and technology constitute a prime productive force. Economic development cannot do without science and technology, and scientific and technological work must be geared to economic construction.

The reform of scientific and technological work is designed to establish a new system which fits the development of the socialist market economy, complies with the laws governing scientific and technological development and integrates science and technology closely with the economic development -- all for the purpose of promoting progress in science and technology, scaling new scientific and technological heights and effecting comprehensive and well-coordinated economic, scientific and technical and social development.

IX. Tightening Up the Legal System

The establishment and improvement of the socialist market economic structure should be codified and guaranteed by an all-inclusive legal system.

We must pay due attention to tightening up the legal system, bringing the effort of reform and opening up to the outside world within the framework of the legal system, and learning how to manage the economy by legal means.

X. Strengthening and Improving Party Leadership and Striving to Initiate a Socialist Market Economic Structure by the End of the 20th Century

To build up the socialist market economic structure and speed up the modernisation drive, we should strengthen and improve leadership by the Party. We should also build up the Party's own strength in order to fulfill the great historical task for the new period.

The Third Plenary Session of the 14th Party Central Committee calls on the entire Party membership and the people of all nationalities throughout the country to rally more closely around the Party Central Committee with Comrade Jiang Zemin as its nucleus. Under the guidance of Deng Xiaoping's theory on building socialism with Chinese characteristics and following the course charted by the 14th Party Congress, let us unite as one and dedicate ourselves heart and soul to the cause of reform, and, by relying on our own efforts and working diligently, strive to initially build up the structure of socialist market economy and realise the strategic goals for the second phase of the nation's socio-economic development by the end of this century!

HONG KONG TEN YEARS OF THE LINKED RATE SYSTEM

1. Introduction

In October 1993 the linked rate system for the Hong Kong dollar celebrated its tenth anniversary. The first part of this paper assesses the pros and cons of the system in broad terms, comparing the system with the alternative monetary regimes. The second part of the paper analyses the main defect of the linked rate system, namely the shortcomings of the cash arbitrage mechanism, and then considers the implications of the proposal put forward by the Hong Kong Monetary Authority (HKMA) to deal with the problem.

2. The Monetary Menu Facing Hong Kong

The linked-rate system for the Hong Kong dollar is often hailed as a convenient "political" solution to the currency crisis of 1983, when the currency plummeted from HK\$6.50 to almost \$10 to the US dollar. But in reality, it was a highly technical response to a critical flaw in Hong Kong's prevailing monetary arrangements -- the authorities' inability to control either the supply or the price of money (expressed in terms of the exchange rate). That the "peg" has worked and has since become an integral part of the rubric of "stability and prosperity" is comforting and important to the people of Hong Kong. If alternatives are put forward, they must be considered on their technical merits first and their political consequences second. The monetary menu facing Hong Kong is the same now as in 1983. There are three broad options: a central bank to control the money supply; a central bank to manage the exchange rate; or the present linked-rate system or some variant of it. Each has advantages and disadvantages. It is not a choice between black and white.

(1) If a central bank was introduced to control the money supply, the single advantage would be that consumer price index (CPI) inflation could be reduced by about five per cent a year if Hong Kong dollar M3 money supply were cut from about 16 per cent a year (its average over the past three years) to say, 11 per cent. However, there would be at least five disadvantages. First, it is not easy to prove that 11 per cent Hong Kong dollar M3 growth is appropriate for Hong Kong, nor would it be easy to hit that target: a huge part of demand is determined from outside, so money growth is affected by changing foreign demand. The corollary and second problem is that the exchange rate must be free to fluctuate and absorb the impact of changes in external demand -- allowing the currency to appreciate when foreign demand is strong, and depreciate when it is weak. But anyone who remembers the terrifying consequences of having a free-floating rate at a time of political crisis will not willingly risk a repetition of 1983. Third, introducing a central bank would require extensive institutional changes, mainly involving a transfer of the clearing house to the central bank so that all banks could maintain an account there, and a complete revision of the note-issuing mechanism. Fourth, having a central bank is risky because it gives the authorities the power to print money. Finally, and perhaps most important, having a central bank essentially means shifting from a monetary rule (HK\$7.80 equals US\$1) to a discretionary system run by officials, who would be subject to political pressure.

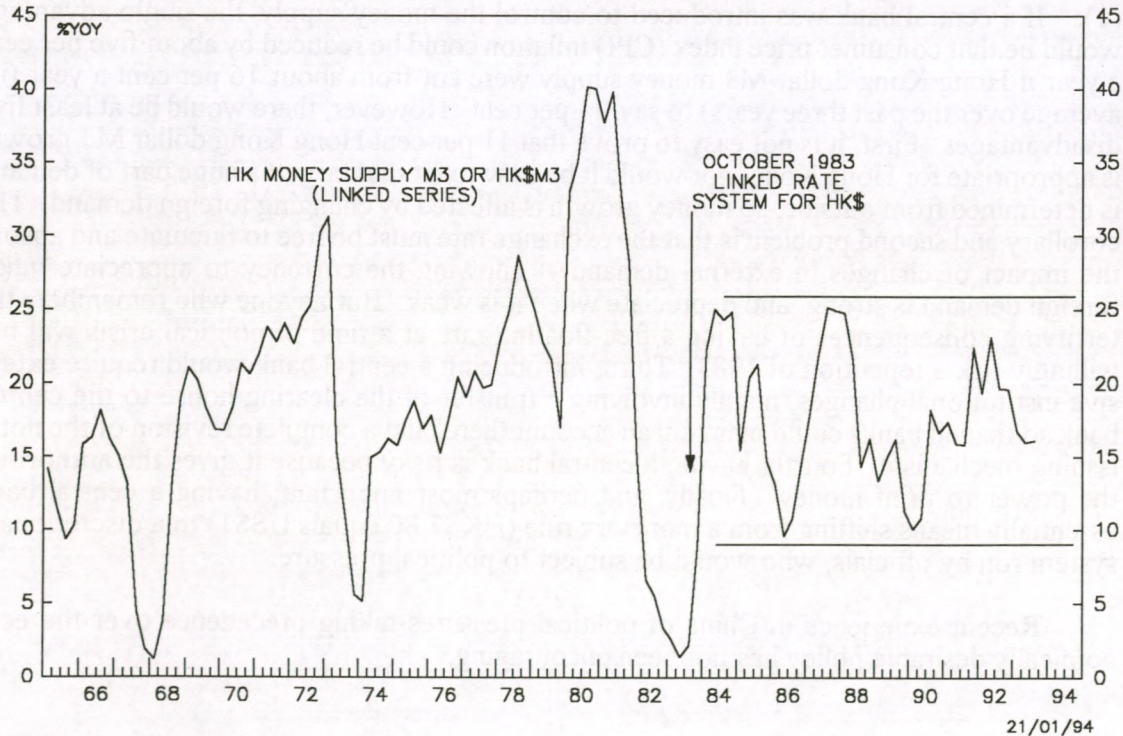
Recent experience in China of political pressures taking precedence over the economically desirable policy has not been encouraging.

(2) The second option is having a central bank to manage the exchange rate, which is the policy pursued by most of the Asian dragon economies. The main advantage would be that, like Singapore, Hong Kong could manage its exchange rate upwards by about five per cent a year to offset a large part of its CPI inflation. This would distribute the gains in living standards from the territory's overall increase in productivity more fairly, but it would not reduce the cost pressures that are causing structural changes in the economy. From a US dollar standpoint, 15 per cent inflation plus 35 per cent appreciation of the Singapore dollar over the past five years are identical to the fifty per cent inflation plus zero currency appreciation that Hong Kong has experienced over the same period. But this option suffers from some of the drawbacks of the first. Also a way must be found of managing the exchange rate. Most Asian economies that have managed the exchange rate upwards against the US currency have exchange controls, but these would violate the Basic Law -- and would represent bad economics.

Another possibility is to combine the two options, but this would only give more discretionary powers to the administrators of the system with no compensating advantages.

(3) The third option -- the linked rate system, or more properly, the currency board system -- also has advantages and disadvantages. Pluses are that the system is rule-based, and largely non-discretionary; the authorities cannot print money; and for exporters, importers and tourists the exchange rate against the US dollar (the currency of Hong Kong's second-largest trading partner, the one to which the yuan is pegged, and the dominant one by volume in the foreign exchange markets) is conveniently stable. Moreover, the system has succeeded in stabilising Hong Kong's monetary growth compared with before 1983.

CHART 1: HONG KONG'S MONEY SUPPLY HAS STABILISED UNDER THE LINKED RATE SYSTEM

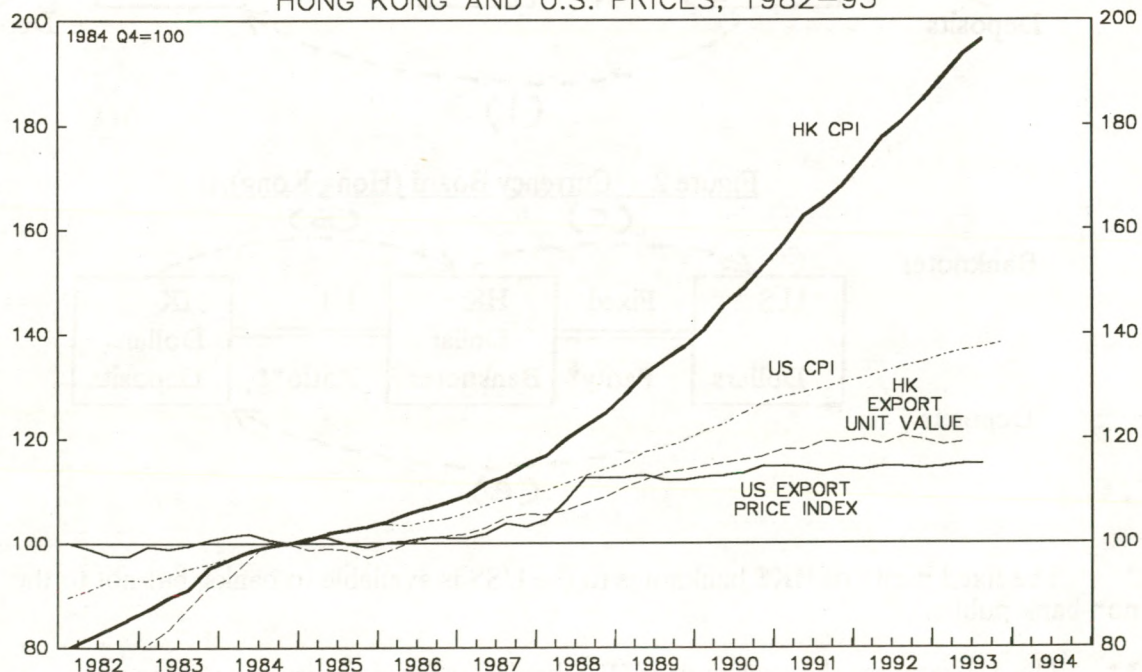


Minuses are that CPI inflation, or non-traded goods-and-service price inflation, considerably exceeds that in the US. This will continue as long as Hong Kong's productivity growth in traded goods (which derives from upgrading low value-added jobs in manufacturing into areas of comparative advantage such as high value-added services) exceeds that in the US. However, as structural changes in the economy are completed and productivity growth slows, CPI inflation will converge towards the US inflation rate. Finally, bank's charges for deposits of more than \$20,000 in Hong Kong dollar banknotes when the free market rate is at a premium to the parity anger large retail customers and create losses for those banks that regularly redeem a lot of notes, since they are obliged to sell Hong Kong dollar notes at 7.8 to the US dollar and buy back Hong Kong dollar funds at a higher price in the forex market.

Modifications to the linked rate system are possible. But changing the 7.8 rate once would destroy confidence in what has been until now a permanently fixed parity. Resetting the rate at, say, 7.4, would trigger expectations of another upward revaluation, so the deviation between the free-market rate and the parity would grow. In short, changing the rate would undermine the mechanism.

Linking the Hong Kong dollar to a basket of currencies, as some suggest, may look attractive but has four major problems. First, it means a continuously changing parity, so speculation about future changes would again lead to wider fluctuations of the free market rate around the parity. Second, as long as China has an unconvertible currency it is impractical for the yuan to be in that basket, despite China being by far the territory's largest trading partner. Third, the composition of the basket would be subject to the same bureaucratic or political discretion as the choice of money growth or the choice of exchange rate under a central bank. Fourth, various studies have shown that a basket peg would not have significantly cut CPI inflation in recent years.

CHART 2: THE LAW OF ONE PRICE
HONG KONG AND U.S. PRICES, 1982-93



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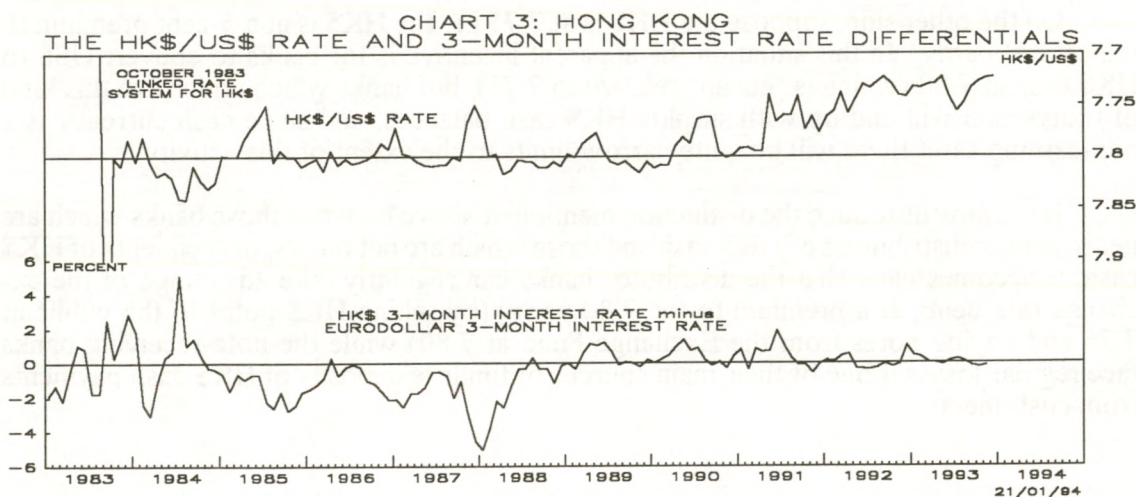
In Figure 1 transactions 1-3 are necessary to conduct arbitrage between differing currency rates for the same quantity of gold. The transactions may be carried out by any party (bank or non-bank), using either banknotes or deposits.

In Figure 2, transaction A can be carried out by banks or non-banks, whereas transaction B can only be conducted by non-banks, and transaction C can only be done at the fixed parity by banks. The rules of the system in Hong Kong drive a wedge between HK\$ banknotes and HK\$ deposits for banks, and between HK\$ banknotes and US dollars for non-banks.

Under present monetary arrangements in Hong Kong, so far as the banks are concerned, HK\$ cash and HK\$ deposits are not convertible into one another at a 1:1 rate. Under the linked rate system banks which require HK\$ banknotes to meet customers' requirements must purchase the banknotes from one of the two note-issuing banks in turn pay US dollars at the same fixed rate to the Exchange Fund to obtain Certificates of Indebtedness (CIs) which authorise them to issue banknotes to a fixed nominal HK\$ value. Conversely, a bank which has banknotes in excess of its requirements can only dispose of them by redeeming the notes with the note-issuing banks again at the fixed rate of HK\$7.80 per US\$1.00. The note-issuing banks in turn redeem CIs with the Exchange Fund or Hong Kong Monetary Authority (HKMA), receiving US\$ in exchange, which they then pass back to the bank which has redeemed the notes.

This arrangement worked well as long as the free market rate for the Hong Kong dollar was either very close to the fixed parity of 7.80, or as long as the free market rate fluctuated evenly on either side of the fixed parity. However, over the past two years the free market rate for the HK\$ has been at a persistent premium to the official exchange rate, generally trading between 7.75 and 7.73, or approaching a 1% premium to the 7.8 parity (see Figures 3 and 4).

Since the deviation has been in existence for so long, the consequences are now beginning to impact on banking practices and could even threaten to introduce new distortions if they are not addressed soon. The solutions that have been introduced on an ad hoc basis to date are relatively problem-free and the costs have been minor, but there are disturbing hints that further measures may be taken which could add a serious distortion to the existing mechanism.



As in other banking and financial centres, there is a natural tendency of banks to specialise in certain types of activity, building up an expertise in particular segments of the market. As they succeed in these areas, they understandably concentrate more resources in these activities. In the Hong Kong market there are broadly two distinctive categories of banks dealing in the banknote business. First, there are those who have developed an expertise in the distribution of HK\$ banknotes both within Hong Kong and to places abroad (e.g. in Taiwan) where there is strong demand for Hong Kong dollars. Second, there are other banks, mainly large local banks with substantial retail customers such as supermarkets, department stores or tourist shopping outlets which find that they are net recipients of HK\$ banknotes on a regular basis. Of course there are other banks which may not have any significant involvement in the banknote business at all, or yet others whose business is roughly balanced as between the distribution and receipt of banknotes.

This specialisation would cause no problem if the free market rate for the Hong Kong dollar were at or close to its parity (within two or three cents), but with the free market rate maintaining a level of around 7.73, the problems inherent in the non-convertibility of cash for deposits are starting to cause knock-on effects elsewhere in the system. The reason is that cash arbitrage has never operated entirely satisfactorily, and the persistence of the free market rate at a premium to the parity over the past two years has exacerbated the problem. We begin with a brief account of how the cash arbitrage should be expected to operate, and then proceed to show how it has been exacerbated by the free market rate remaining at a premium.

Suppose the HK\$ is at 7.85 i.e. at a 5-cent discount to the 7.80 parity. Under the rules of the linked rate system established in 1983 the non-bank public is not entitled to convert HK dollar cash or notes to US dollars at the official parity with the Exchange Fund, and the banks will normally deal with the public at prices close to 7.85. Only the banks have the ability to convert HK\$ cash to US\$ at the official parity, assuming they have an incentive to do so. However, their willingness to redeem cash will be constrained by their individual holdings of till cash or vault cash. Only those banks with excess HK\$ cash will be willing to redeem banknotes. Other banks will not convert HK\$ banknotes to US\$ lest they are caught short of HK\$ cash to meet their depositors' normal requirements i.e. banks will not willingly reduce their cash holdings below what they deem to be a desirable ratio of cash to deposits.

On the other side, suppose the HK\$ is at 7.75 i.e. the HK\$ is at a 5-cent premium to the official parity. In this situation the apparent incentive is for banks to convert US\$ to HK\$ cash at 7.80 (which is "cheap" relative to 7.75), but banks which undertake this kind of transaction will end up with surplus HK\$ cash balances, and since cash currency is a non-earning asset there will be quite narrow limits to the extent of this activity.

If we now introduce the distinction mentioned above between those banks which are net issuers or distributors of HK\$ cash and those which are net takers, or recipients of HK\$ cash, it becomes clear that the distributor banks can regularly take advantage of the exchange rate being at a premium to the 7.80 parity (by selling HK\$ notes to the public at 7.75 and buying notes from the Exchange Fund at 7.80) while the note-receiving banks face regular losses if one of their main sources of funds is deposits of HK\$ cash payments from customers.

To illustrate this problem we set out below a T-form balance sheet of a typical Hong Kong bank which receives cash from large retail customers. In step (1) the customer deposits HK\$75,000 in cash and is credited with a deposit of HK\$75,000. Let us assume that the bank at this stage is holding excess vault cash of HK\$75,000. In step (2) the bank converts the HK\$75,000 banknotes into US dollars via the Exchange Fund, obtaining proceeds of US\$9,615.38 at the official 7.80 parity. In step (3), because the bank does not wish to hold US dollars but wants a HK dollar asset to match the HK\$75,000 deposit due to his customer, it must now sell the US\$9,615.38 which it obtained from the Exchange Fund on the (free) foreign exchange market in Hong Kong. At the going rate of 7.75 this will yield proceeds of HK\$74,519.19, or HK\$480.81 less than the original HK\$75,000 deposit which it accepted.

To overcome these apparent losses, banks in Hong Kong have been charging their customers a handling fee of 0.5 - 1.0% for cash deposits in excess of HK\$20,000.

Net Cash - Receiving Bank

(Assets)		(Liabilities)	
(1)	HKD Cash (Banknotes) 75,000	HKD Deposit	75,000
(2)	HKD Cash 75,000 sold at 7.80 at Exchange Fund for USD yielding US\$9,615.38	HKD Deposit	75,000
(3)	USD 9,615.38 sold in HK forex market at 7.75 yielding proceeds of HK\$74,519.19	HKD Deposit	75,000

In addition there are suggestions that discontent is building up among the note-receiving banks against the note-distributing banks, and that penalties or other sanctions may be imposed on persistent note-distributors to even things up, even though the official rules of the system require the two note-issuing banks to deal at HK\$7.80 per US\$1.00 with all other banks. In effect the note-receiving banks are blaming the note-distributing banks, when in reality the problem is not of the latter's making at all.

When the linked rate system was established in 1983, a decision was made that all non-note-issuing banks should be able to buy and sell HK\$ banknotes from the note-issuing banks at the official rate of HK\$7.80 = US\$1.00. This mechanism, known as the pass-on arrangement, was intended to place all banks on an equal footing. However, specialisation among banks and the persistent deviation of the free market rate from the official parity have effectively undermined that intention, so now it is time for a re-appraisal.

The solution which has been proposed by the Hong Kong Monetary Authority is that the pass-on arrangement be terminated so that in future the non-note-issuing banks would be supplied with HK\$ currency against their clearing balances at the note-issuing banks for Hong Kong dollar value. Under such a proposal, banks other than non-note-issuers will not incur any exchange gain or loss because their drawdowns or deposits of HK\$ banknotes

will be against their HK\$ clearing accounts at the note-issuing banks.

Clearly, this would be an improvement so far as customers of non-note-issuing banks are concerned because they would no longer be faced with the charges now imposed for deposits of cash in excess of HK\$20,000. Much of the antagonism generated by these fees would evaporate. Moreover, note-distributing banks would not be able to exploit the gap between the "cheap" HK dollars available (in effect) from the Hong Kong Monetary Authority, and the "expensive" HK dollars available in the free market.

However, for the note-issuers the position is very different. They would clearly benefit when the exchange rate was on the strong side, i.e. at a premium to the 7.80 parity, but they would make corresponding losses if the HK\$ rate shifted to (say) HK\$7.82 or weaker. If the HK\$ rate was at a premium to the parity, the profits that the note-issuers made by obtaining notes at 7.80 and selling them at (say) 7.73 to some overseas customers would be substantial. (Note that there might be some redistribution of these profits among the note-issuing banks themselves since they are unlikely to be note-receivers and note-distributors in the same proportions.) Conversely, if the exchange rate was at a discount to the parity the note-issuers would make losses on sales of notes to customers who paid in foreign currency.

For the note-issuing banks there would clearly be an incentive to do what they could to keep the exchange rate on the strong side of the parity. If the rate deviated on the weak side (e.g. 7.85), the note-issuing banks would have some additional incentive to restrict loans, reduce monetary growth, raise interest rates and generally put the automatic corrective mechanism into operation. By the same token, if the free market rate was on the strong side of the parity (e.g. 7.75) the note-issuing banks would have no such incentive to implement any measures which would tend to shift the rate back towards the official parity. As a result, we can conclude that making the HK\$ clearing accounts of non-note-issuing banks convertible into HK\$ banknotes will not fully solve the problem of the deviation of the free market rate from the parity. It will enable the note-receiving banks to avoid some losses which occur under the present system when the free market rate is at a premium to the parity, but it does not set up any mechanism for closing the gap between the free market rate and the parity, at least when the free market rate is on the strong side of the parity.

CONCLUSION: Hong Kong's dollar peg is basically a modern version of the old gold or silver standard, using the US dollar instead of a precious metal. Under the true gold and silver standards of the 18th and 19th centuries, parities remained unchanged for many decades. Insofar as the Hong Kong system is a replica of the gold or silver standard, the territory would be best served by maintaining its current 7.80 parity to the US dollar for at least one more decade, and preferably for many more.

However, insofar as the precise analogue of gold-for-currency arbitrage does not exist in the present day Hong Kong system, some modifications of the gold standard machinery have become necessary. The present proposal of the HKMA, which in effect would limit access to the 7.80 window to the note-issuing banks only, would eliminate one problem (namely, the charge imposed on depositors of banknotes in excess of HK\$20,000) but introduce a new set of problems (namely, a bias in favour of keeping the free market rate on the strong side of the parity). The mechanism may not be perfect, but in Hong Kong's circumstances these defects are minor and well worth the cost of maintaining a rule-based, non-discretionary and non-politicised monetary system.

MALAYSIA STERILISATION MAKES CENTRAL BANK AIMS LESS VISIBLE

Introduction: The Economic Backdrop

Over the last 12-18 months Malaysia has seen a substantial upturn in its foreign exchange reserves position. Given its heavily managed exchange rate policy -- the monetary authorities intervened to depreciate the RM/US\$ by 5% in December -- this has put upward pressure on the quantity of high powered money in its monetary system. However, so far the Central Bank has been sterilising the expansionary effects of its foreign exchange intervention by simultaneously borrowing from the commercial banks. In contrast to the more typical export driven monetary stimulus, the current source of high powered money expansion is mostly from the capital account of the balance of payments. Foreign exchange reserves have been raised by higher net capital inflows on the balance of payments as well as by a recent narrowing of the current account deficit.

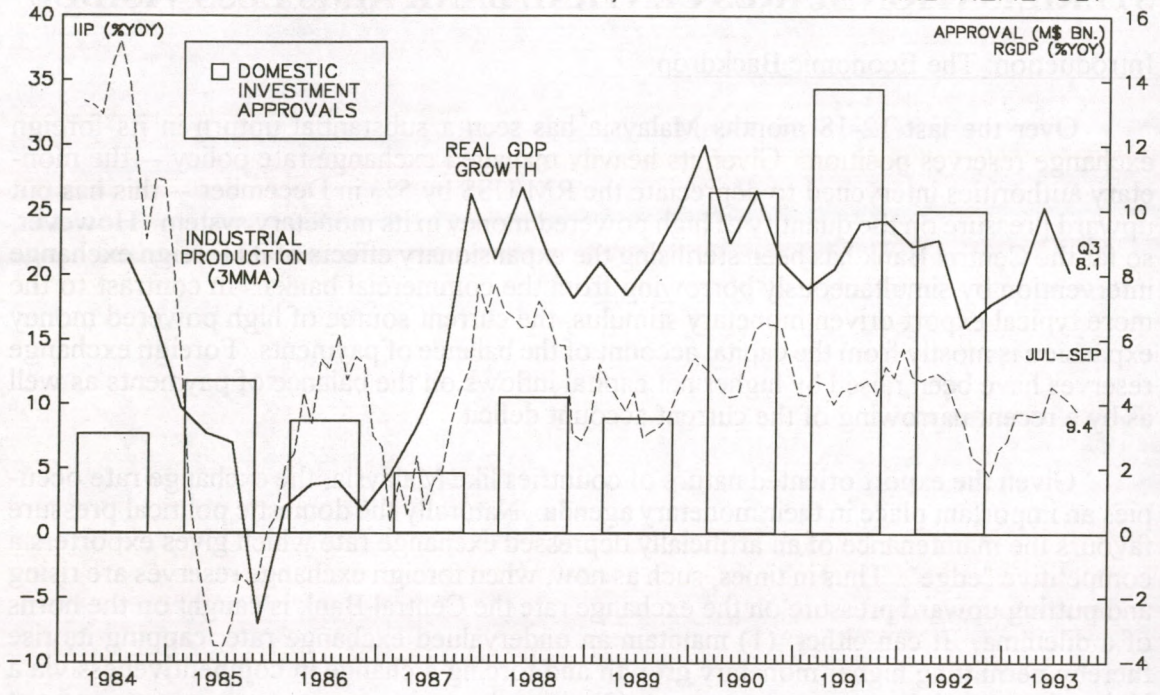
Given the export oriented nature of countries like Malaysia, the exchange rate occupies an important place in their monetary agenda. Naturally the domestic political pressure favours the maintenance of an artificially depressed exchange rate which gives exporters a competitive "edge". Thus in times, such as now, when foreign exchange reserves are rising and putting upward pressure on the exchange rate the Central Bank is caught on the horns of a dilemma. It can either: (1) maintain an undervalued exchange rate, capping its rise thereby permitting higher monetary growth and forcing a change in competitiveness via a higher domestic inflation rate later on, or (2) allow the exchange rate to appreciate and not let the improved balance of payments position feed through to the domestic money supply or domestic inflation. In both cases exports lose competitiveness. However, in the second case this is more visible and immediate: politically therefore a less likely course of action. Moreover, a middle path is not available, that is, the economy's exports must lose some of their international price competitiveness, if the forces behind the improvement in the overall balance of payments are sustained. The central bank of Malaysia (Bank Negara Malaysia, BNM) has encountered precisely this choice in recent months and has opted for the exchange rate capping solution with the added twist that it has so far "sterilised" its foreign exchange intervention. This will turn out to be unsustainable as the domestic economy strengthens.

This article proceeds with a brief review and discussion of the current state of the Malaysian economy. Afterwards questions arising from the ultimate aim, sustainability and effectiveness of the sterilised intervention policy are dealt with. A similar experience encountered by the Central Bank of China (CBC) in Taiwan suggests that (1) BNM may be forced to let the RM/US\$ appreciate in the months ahead and that (2) BNM will be faced with the decision to tighten monetary policy after the domestic demand for credit at current interest rates has risen and as the current sterilisation policy is phased out.

Recent Developments in Malaysia

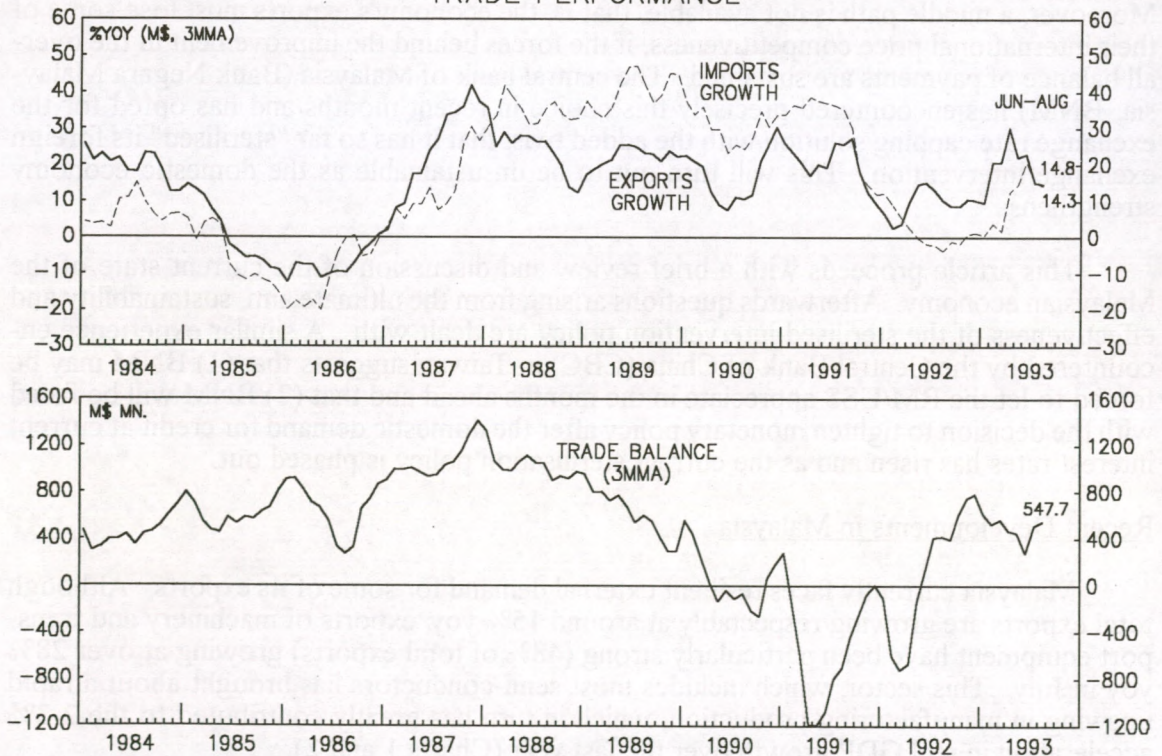
Malaysia currently faces resilient external demand for some of its exports. Although total exports are growing respectably at around 15% yoy, exports of machinery and transport equipment have been particularly strong (48% of total exports) growing at over 28% yoy in July. This sector, which includes most semi-conductors has brought about a rapid upswing in manufacturing production, which in turn has greatly contributed to the 2-3% acceleration in real GDP growth over the last year (Charts 1 and 2).

MALAYSIA: CHART 1
DOMESTIC INVESTMENT APPROVALS, GROWTH OF IIP AND REAL GDP



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MALAYSIA: CHART 2
TRADE PERFORMANCE



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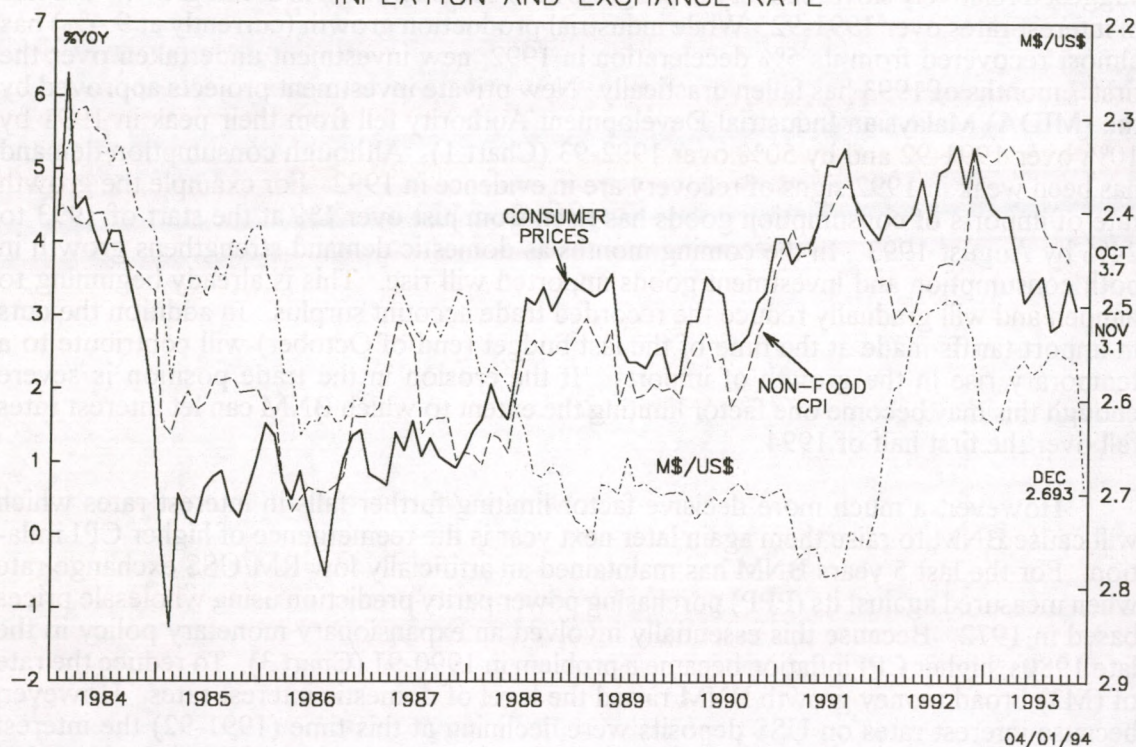
Notwithstanding this buoyant GDP growth, indicators of domestic economic activity suggest a relatively slow recovery in progress after the slowdown in credit growth and rise in interest rates over 1991-92. While industrial production growth (currently at 9.4%) has almost recovered from its 5% deceleration in 1992, new investment undertaken over the first 7 months of 1993 has fallen drastically. New private investment projects approved by the (MIDA) Malaysian Industrial Development Authority fell from their peak in 1991 by 10% over 1991-92 and by 50% over 1992-93 (Chart 1). Although consumption demand has been weak in 1992 signs of recovery are in evidence in 1992. For example the growth rate of imports of consumption goods has risen from just over 1% at the start of 1993 to 24% by August 1993. In the coming months as domestic demand strengthens growth in both consumption and investment goods imported will rise. This is already beginning to happen and will gradually reduce the recorded trade account surplus. In addition the cuts in import tariffs made at the time of the last budget (end of October) will contribute to a temporary rise in the growth of imports. If the erosion in the trade position is severe enough this may become one factor limiting the extent to which BNM can let interest rates fall over the first half of 1994.

However, a much more decisive factor limiting further falls in interest rates which will cause BNM to raise them again later next year is the reemergence of higher CPI inflation. For the last 5 years BNM has maintained an artificially low RM/US\$ exchange rate when measured against its (PPP) purchasing power parity prediction using wholesale prices based in 1972. Because this essentially involved an expansionary monetary policy in the late 1980s, higher CPI inflation became a problem in 1990-91 (Chart 3). To reduce the rate of (M3) broad money growth BNM raised the level of domestic interest rates. However, because interest rates on US\$ deposits were declining at this time (1991-92) the interest rate differential that emerged attracted high net inflows of capital into Malaysia and boosted foreign exchange reserves (Charts 4, 5 and 8). This in turn put upward pressure on the RM/US\$ and, although BNM initially allowed some appreciation in 1992, it capped the RM/US\$ (as it continues to do today) keeping the rate artificially low. To prevent this foreign exchange intervention from significantly reversing its tight money policy BNM sterilised its intervention (by simultaneously borrowing from the commercial banks). However, despite this sterilised intervention broader money has reaccelerated back to 1990 growth rates. Nevertheless, the higher interest rates in 1992 together with the temporary controls on consumer lending in place brought down bank and non bank credit growth (Chart 5). In response to this BNM has let banks lower their lending and 3 month deposit rates by around 1% to 8% and 6.7% respectively during 1993.

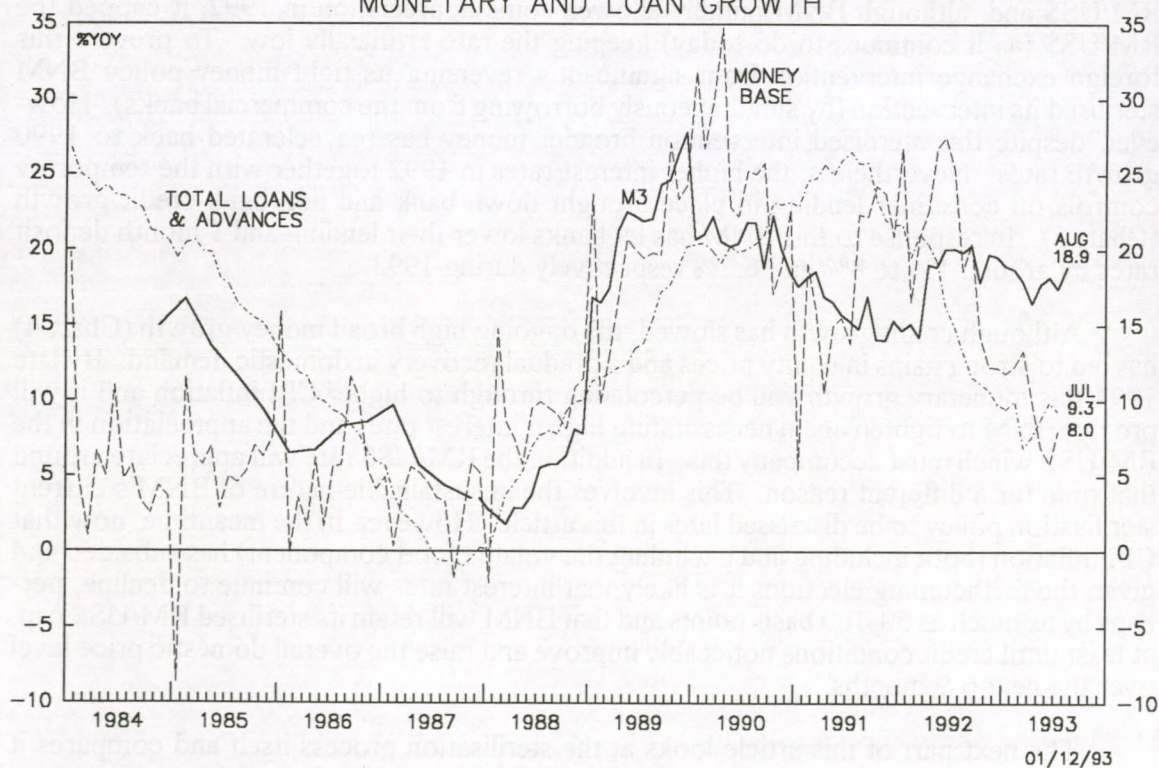
Although credit growth has slowed, the ongoing high broad money growth (Chart 4) has led to strong gains in equity prices and a gradual recovery in domestic demand. By late 1994 this monetary growth will be percolating through to higher CPI inflation and it will prompt BNM to tighten again necessitating higher interest rates and the appreciation in the RM/US\$ which must accompany this. In addition the RM/US\$ rate will appreciate around that time for a different reason. This involves the unsustainable nature of BNM's current sterilisation policy to be discussed later in this article. However, in the meantime, now that CPI inflation (both including and excluding the volatile food component) has subsided and given the forthcoming elections it is likely that interest rates will continue to decline, perhaps by as much as 50-100 basis points and that BNM will retain its sterilised RM/US\$ cap, at least until credit conditions noticeably improve and raise the overall domestic price level over the next 6-9 months.

The next part of this article looks at the sterilisation process itself and compares it with that in Taiwan over the latter part of the 1980s.

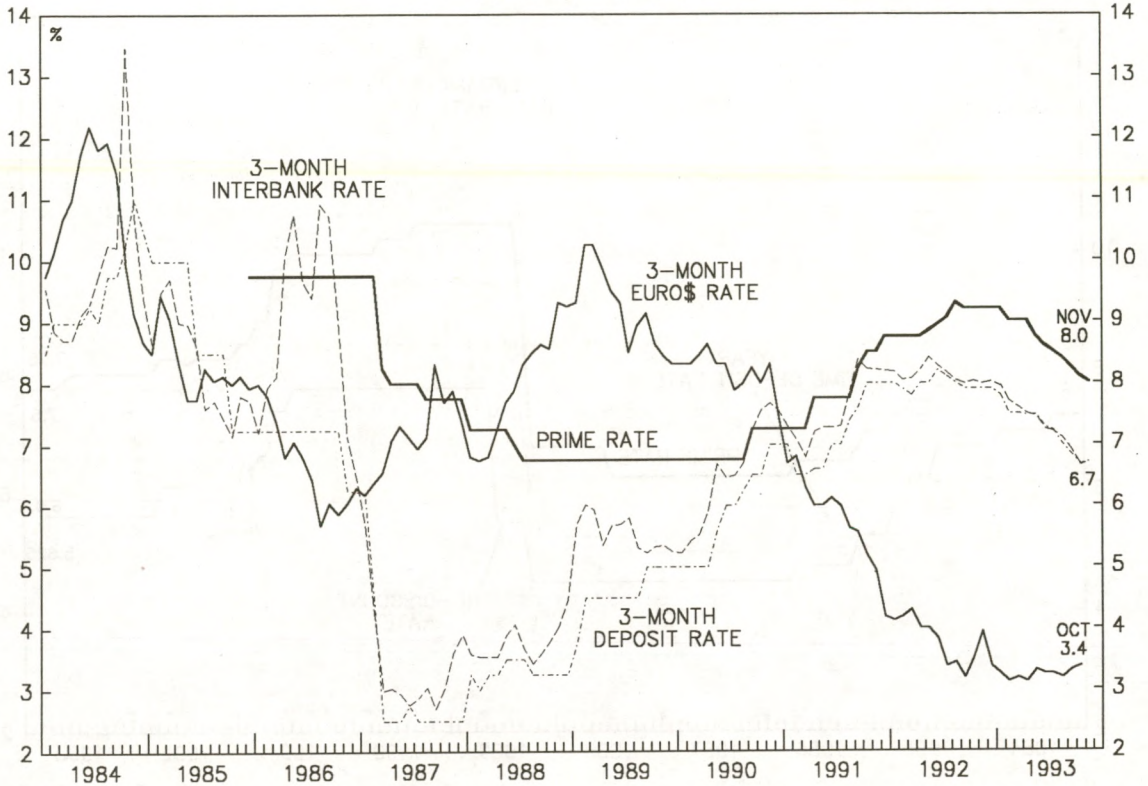
MALAYSIA: CHART 3
INFLATION AND EXCHANGE RATE



MALAYSIA: CHART 4
MONETARY AND LOAN GROWTH



MALAYSIA: CHART 5
INTEREST RATES

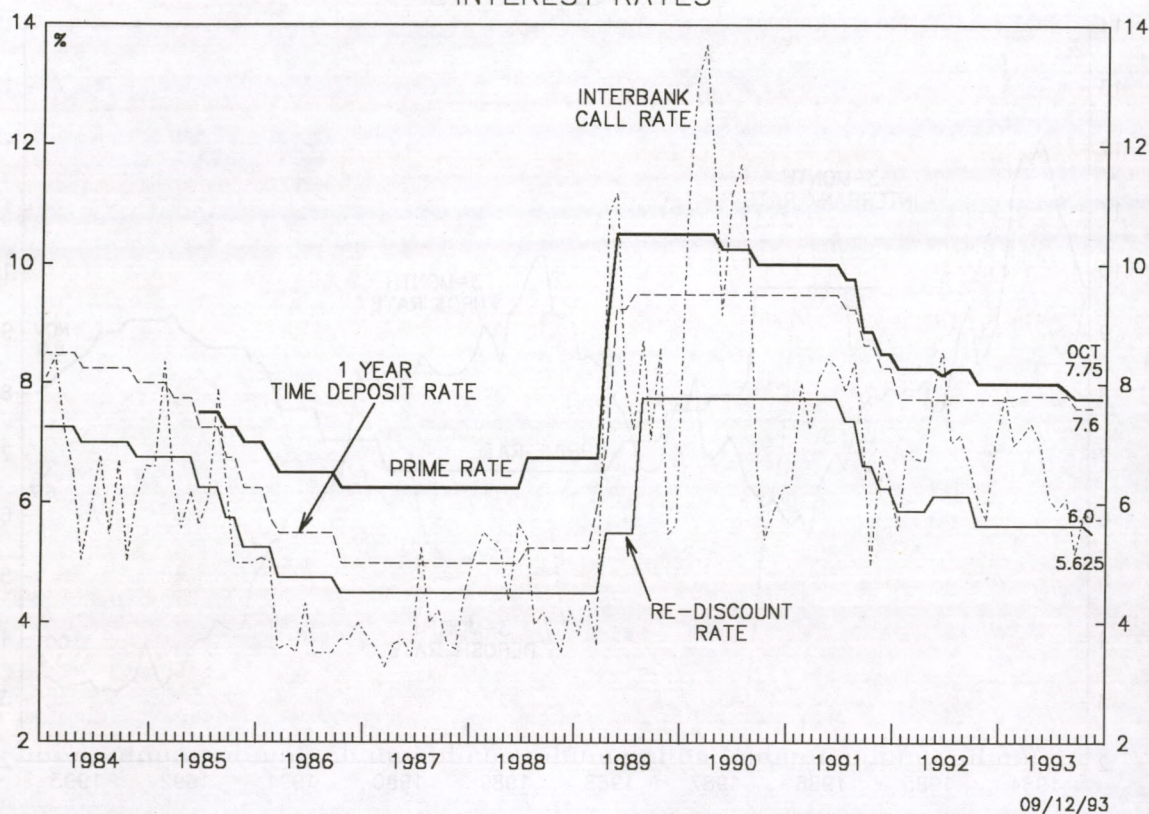


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Sterilisation - Part 1: The Taiwanese Experience

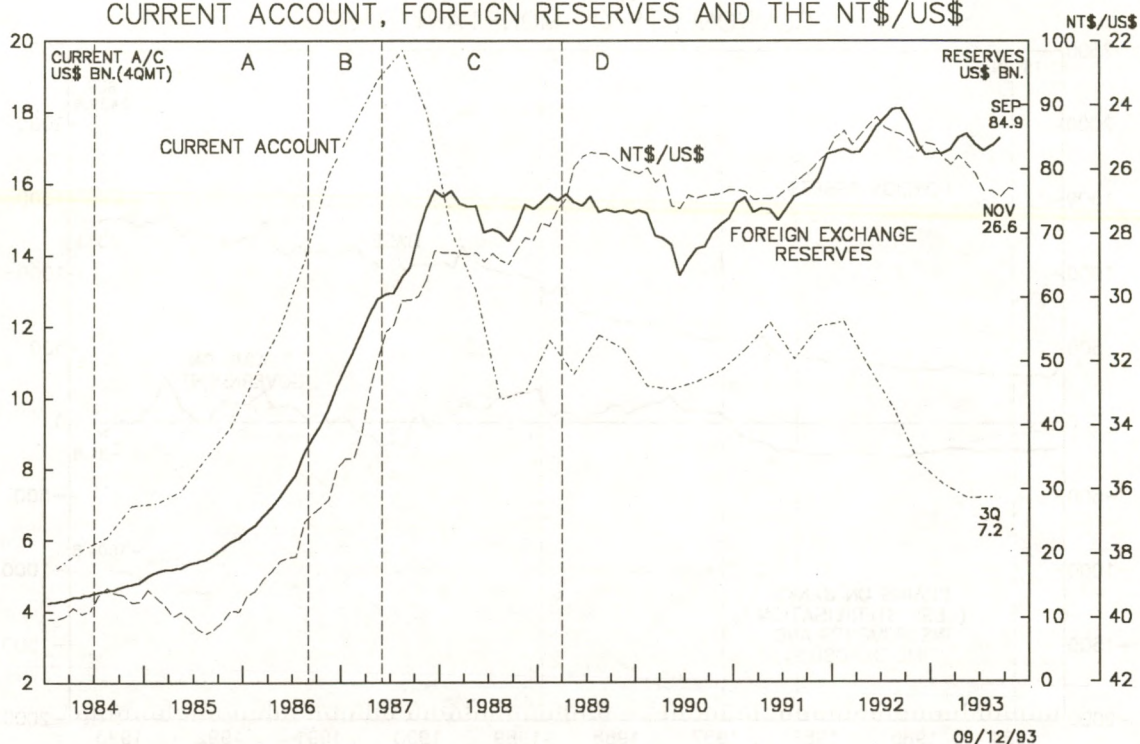
Taiwan experienced a period very similar to Malaysia's in the mid to late 1980s when its foreign exchange reserves rose dramatically, and its central bank, the Central Bank of China (CBC) conducted sterilised intervention. The whole episode can be divided into three separate periods, indicated on Charts 7 to 10 by the letters A, B & C. During the first period, which ran from mid 1984 to mid 1986 net exports grew rapidly causing the current account surplus to increase substantially. The capital account remained fairly stable over this time because, unlike BNM in Malaysia, the CBC kept the capital account virtually closed. This, together with the undervalued NT\$/US\$ exchange rate policy that the CBC was then pursuing, led to an expansion in foreign exchange reserves. The CBC was temporarily able to achieve its dual objective of maintaining an undervalued NT\$/US\$ while keeping M2 growth steady because private sector loan demand was weak at that time: a factor behind the falling interest rates (Chart 6). Meanwhile, commercial banks found that they had growing excess reserves. To try and prevent the higher level of foreign exchange reserves from feeding through to faster monetary base growth the CBC sterilised its foreign exchange intervention by at first selling government securities to the banks and later by issuing its own liabilities to fulfill the same role.

TAIWAN: CHART 6
INTEREST RATES

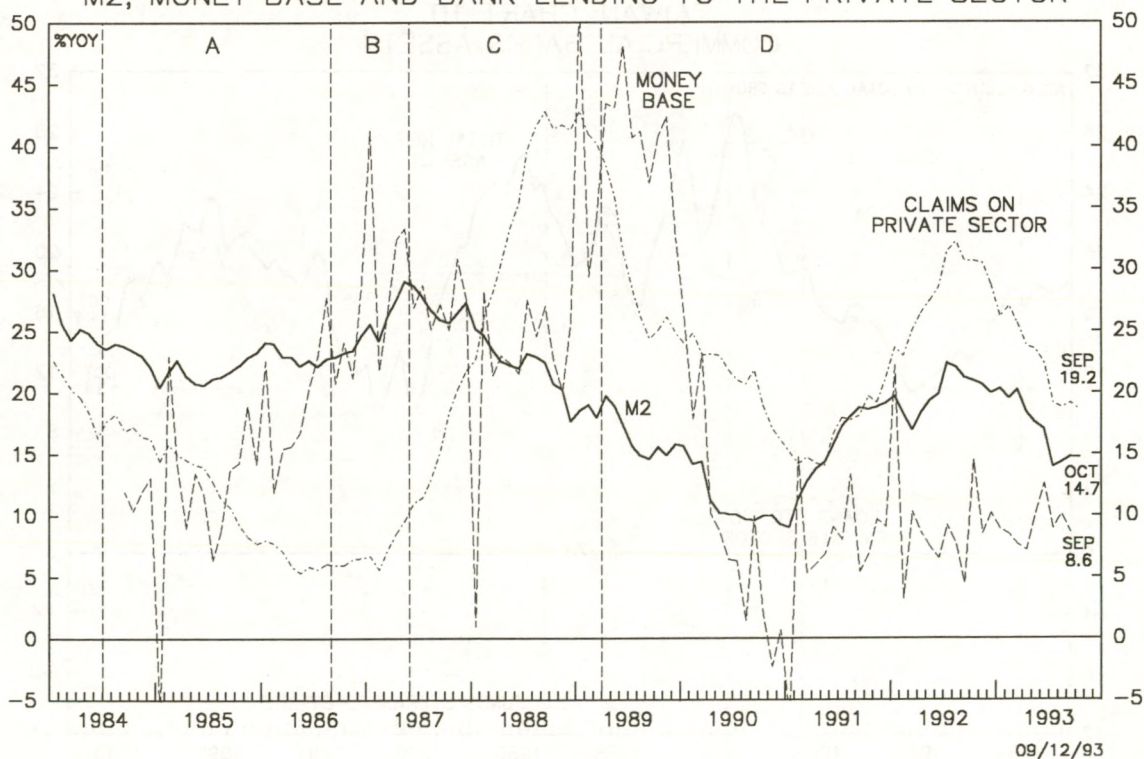


From the end of 1986 to mid 1987 (period B), interest rates had fallen to levels which brought about a boost in the domestic demand for credit (Chart 6). As a result both stock and property markets boomed around this time. The CBC was then faced with three options over its exchange rate policy. These are essentially the same as those which now face BNM in Malaysia. The first, and most expansionary was to intervene to keep the exchange rate undervalued, but not to sterilise this operation. Commercial Banks would then be able to extend credit to the private sector without the crowding out that would occur as a necessary consequence of any sterilisation operations. The second option was to let the exchange rate appreciate freely thus precluding any additional faster money growth and domestic expansion, enabling the price adjustment of Taiwanese exports to be taken through the exchange rate rather than through a higher inflation rate. The final option -- a non-option -- would have been to continue with its sterilised intervention. This would have required a degree of crowding out of some private sector loans which would have resulted in some firming of interest rates. This in turn would serve to strengthen the exchange rate, placing greater expectations in the minds of bankers and other lenders that the NT\$/US\$ may significantly appreciate and that the foreign exchange intervention was not a policy which would be in place for much longer. Thus in the longer run, as the demand for credit expanded, this sterilisation policy would have become unsustainable and therefore not credible. The CBC would not have been able to control both the exchange rate (using the foreign exchange intervention) while at the same time keeping money and credit growth "in check" (via the sterilisation instruments). It had to choose between them.

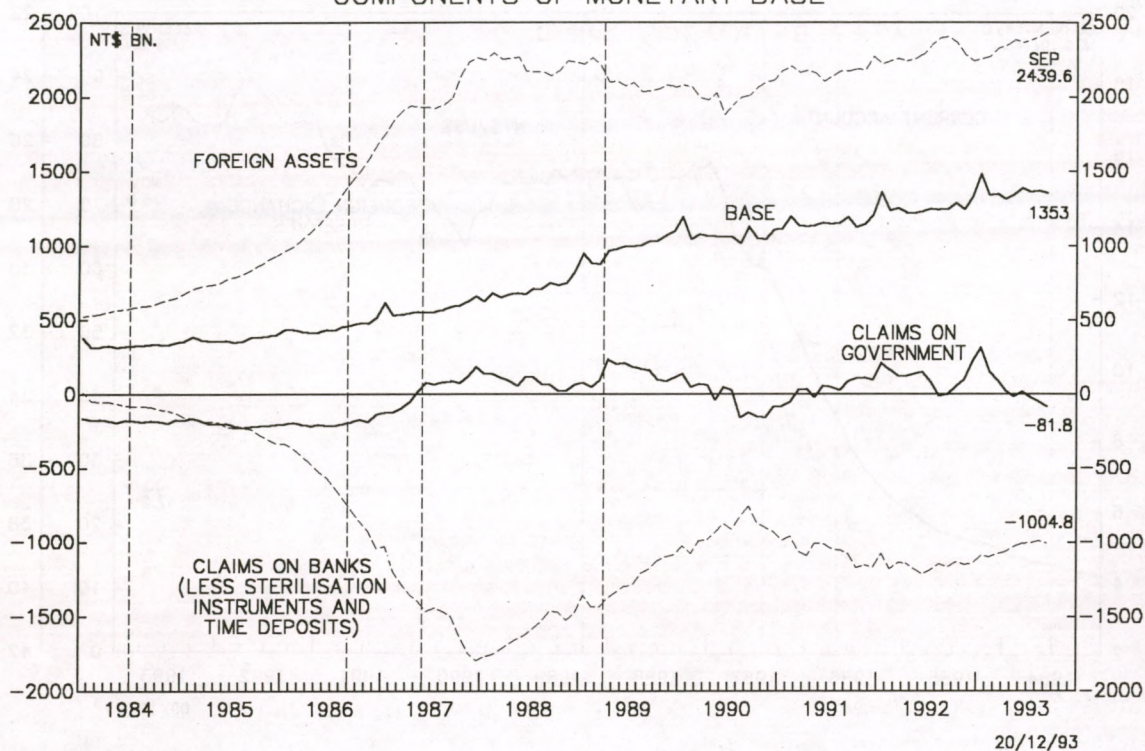
TAIWAN: CHART 7
CURRENT ACCOUNT, FOREIGN RESERVES AND THE NT\$/US\$



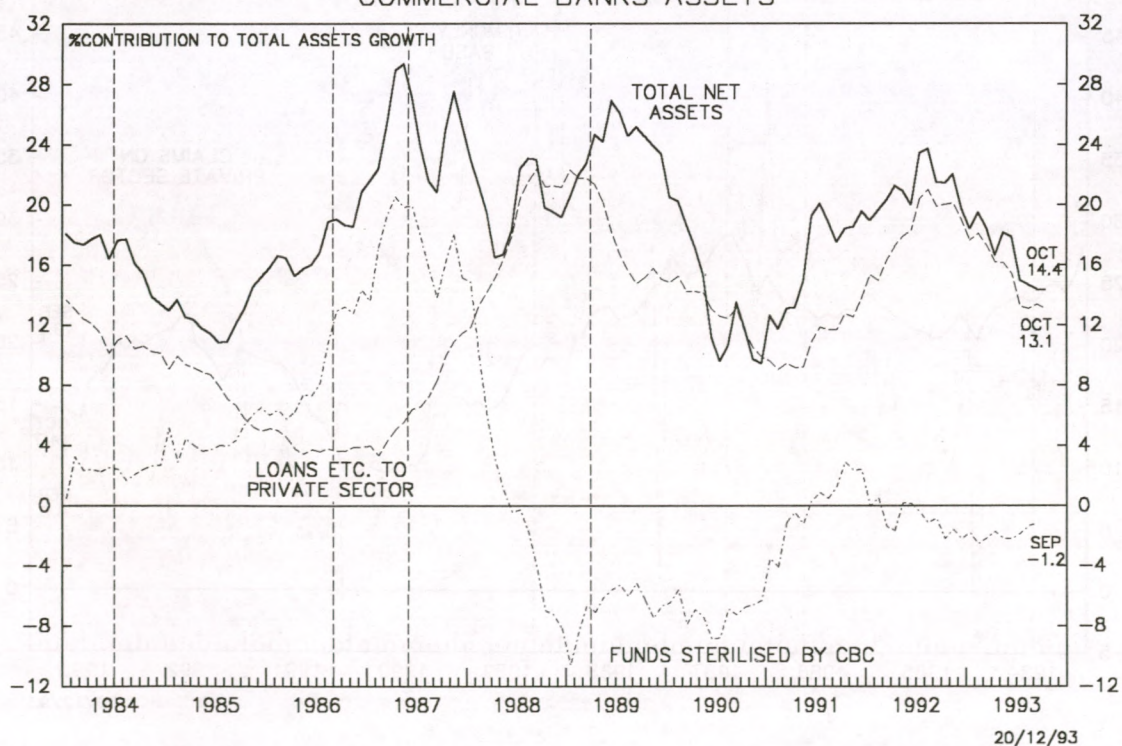
TAIWAN: CHART 8
M2, MONEY BASE AND BANK LENDING TO THE PRIVATE SECTOR



TAIWAN: CHART 9
COMPONENTS OF MONETARY BASE



TAIWAN: CHART 10
COMMERCIAL BANKS ASSETS



In the end the CBC let the exchange rate appreciate permitting banks to expand their loan growth, uninhibited by the crowding out nature of the sterilisation instruments. Both loan growth and M2 growth began to accelerate in 1987.

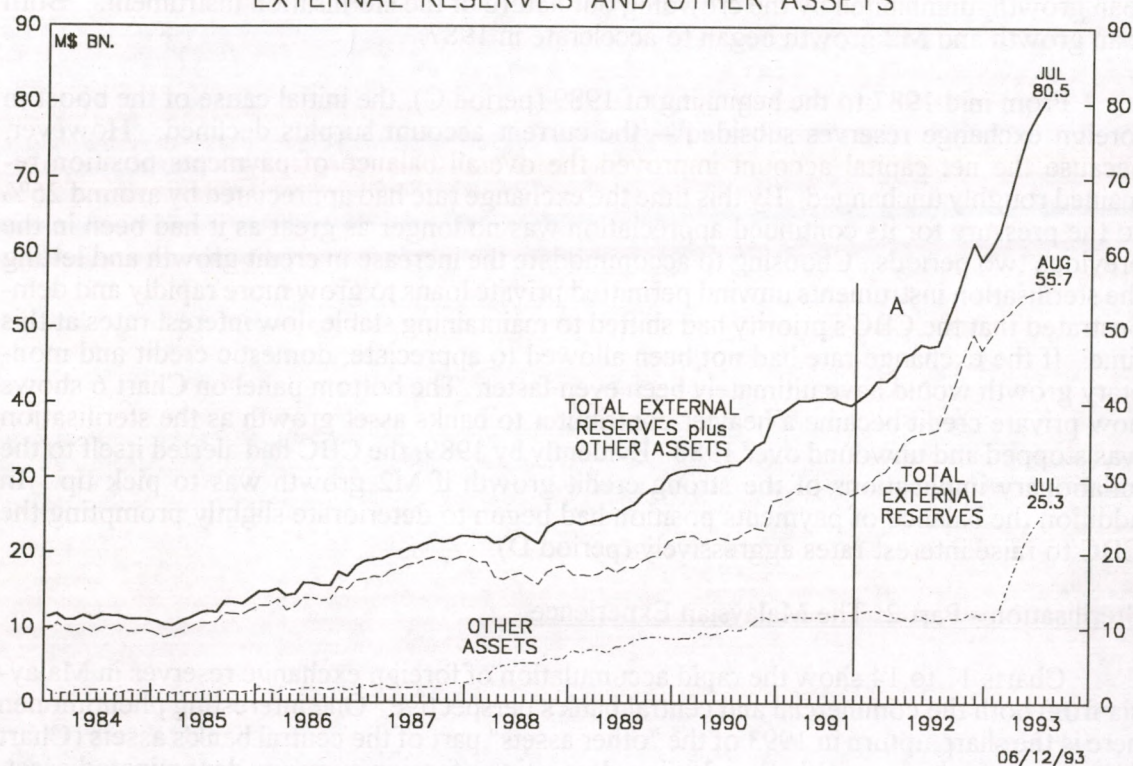
From mid 1987 to the beginning of 1989 (period C), the initial cause of the boost in foreign exchange reserves subsided -- the current account surplus declined. However, because the net capital account improved the overall balance of payments position remained roughly unchanged. By this time the exchange rate had appreciated by around 25% so the pressure for its continued appreciation was no longer as great as it had been in the previous two periods. Choosing to accommodate the increase in credit growth and letting the sterilisation instruments unwind permitted private loans to grow more rapidly and demonstrated that the CBC's priority had shifted to maintaining stable, low interest rates at this time. If the exchange rate had not been allowed to appreciate, domestic credit and monetary growth would have ultimately been even faster. The bottom panel on Chart 6 shows how private credit became a heavier contributor to banks asset growth as the sterilisation was stopped and unwound over 1988. Evidently by 1989, the CBC had alerted itself to the inflationary implications of the strong credit growth if M2 growth was to pick up. In addition the balance of payments position had begun to deteriorate slightly prompting the CBC to raise interest rates aggressively (period D).

Sterilisation - Part 2: The Malaysian Experience

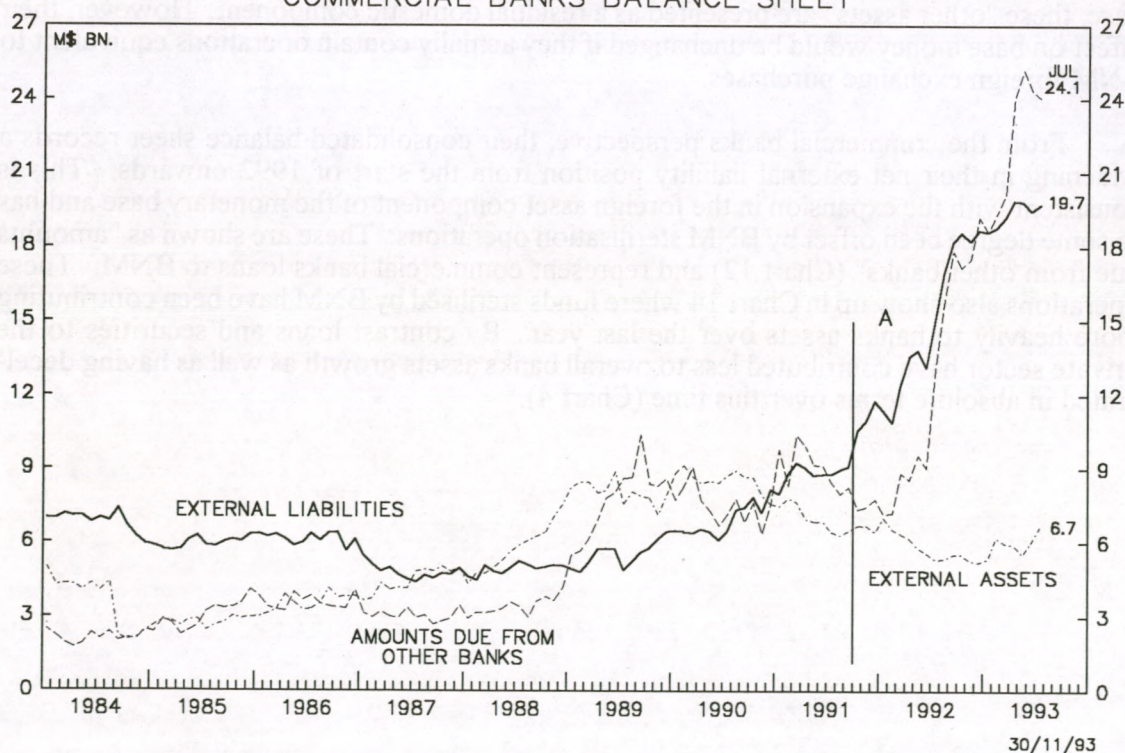
Charts 11 to 14 show the rapid accumulation of foreign exchange reserves in Malaysia from both the commercial and central bank's perspective. One interesting phenomenon here is the sharp upturn in 1993 of the "other assets" part of the central bank's assets (Chart 11): content unknown. Whether this is a domestic or foreign currency denominated asset, it represents an operation, not previously conducted prior to February 1993, which helps to boost monetary base growth. In Chart 13 which shows the decomposition of the monetary base, these "other assets" are presented as a residual domestic component. However, their effect on base money would be unchanged if they actually contain operations equivalent to BNM foreign exchange purchases.

From the commercial banks perspective, their consolidated balance sheet records a widening in their net external liability position from the start of 1992 onwards. This is consistent with the expansion in the foreign asset component of the monetary base and has to some degree been offset by BNM sterilisation operations. These are shown as "amounts due from other banks" (Chart 12) and represent commercial banks loans to BNM. These operations also show up in Chart 14 where funds sterilised by BNM have been contributing more heavily to banks assets over the last year. By contrast loans and securities to the private sector have contributed less to overall banks assets growth as well as having decelerated in absolute terms over this time (Chart 4).

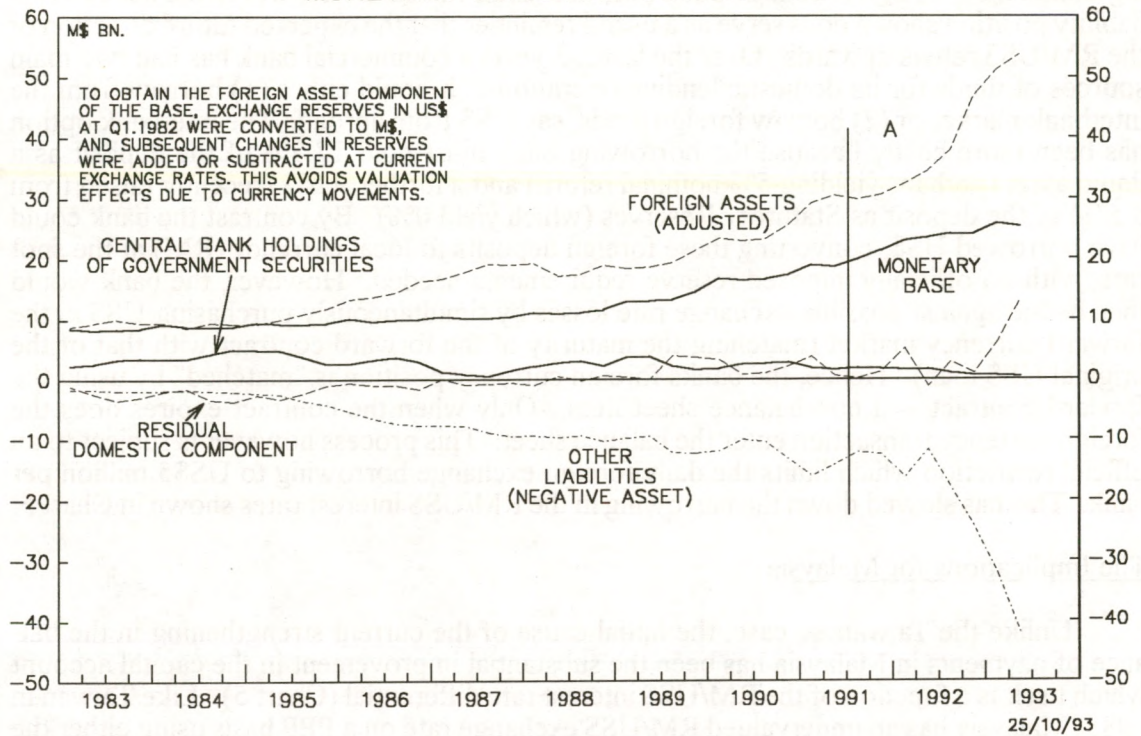
MALAYSIA: CHART 11
EXTERNAL RESERVES AND OTHER ASSETS



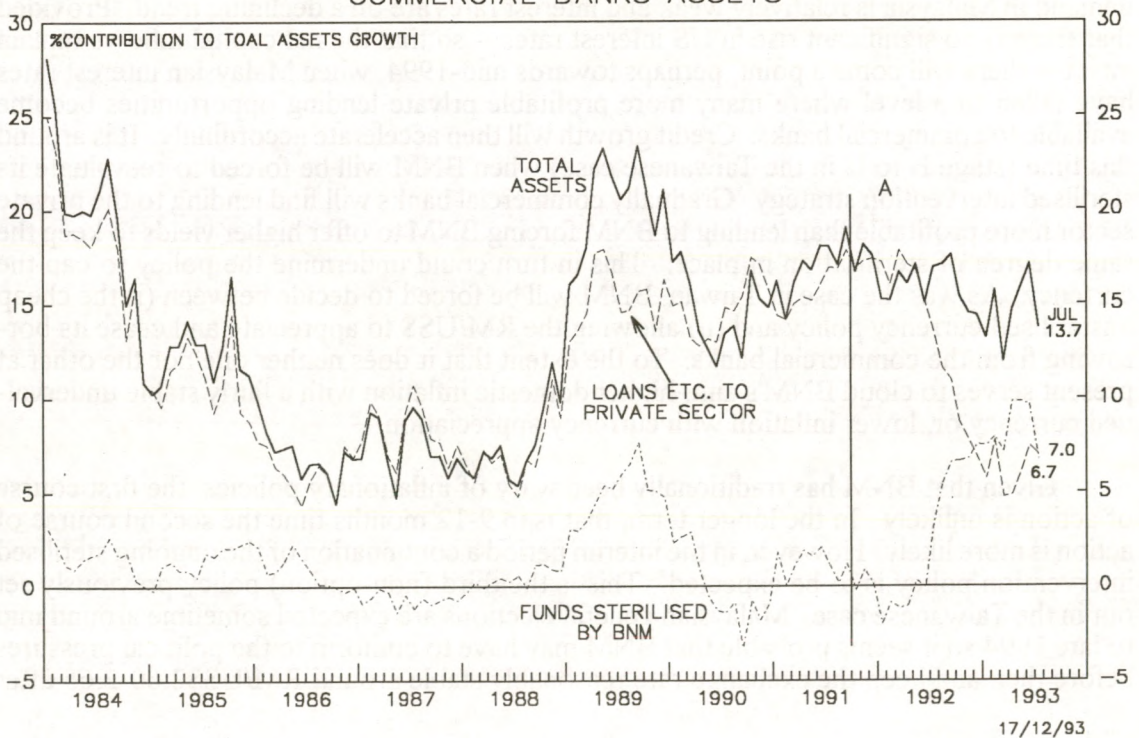
MALAYSIA: CHART 12
COMMERCIAL BANKS BALANCE SHEET



MALAYSIA: CHART 13
MONETARY BASE AND COMPONENTS



MALAYSIA: CHART 14
COMMERCIAL BANKS ASSETS



Although, from Chart 12 it looks as though commercial banks in Malaysia are holding unmatched foreign exchange positions, this is not the case. However the net external liability position shown does serve as a useful reminder that the expected future direction of the RM/US\$ rate is upwards. Over the last 2-3 years a commercial bank has had two main sources of funds for its domestic lending operations. It could either (1) borrow from the interbank market or (2) borrow foreign funds, say US\$ from abroad. The interbank option has been more costly because the borrowing bank must hold 17.5% of the deposit as a liquid asset (perhaps yielding 5% nominal return) and a further 9.5% (recently raised from 8.5%) of the deposit as Statutory Reserves (which yield 0%). By contrast the bank could have borrowed US\$, converting these foreign deposits to local currency (RM) at the spot rate, with no officially imposed reserve requirements needed. However, the bank would then hedge against possible exchange rate losses by simultaneously purchasing US\$ in the forward currency market (matching the maturity of the forward contract with that of the original US\$ loan). Hence, the banks foreign currency position is "matched" by using the forward contract -- a non-balance sheet item. Only when the contract expires does the foreign currency transaction enter the balance sheet. This process however is subject to an official restriction which limits the daily foreign exchange borrowing to US\$5 million per bank. This has slowed down the narrowing in the RM/US\$ interest rates shown in Chart 5.

The Implications for Malaysia

Unlike the Taiwanese case, the initial cause of the current strengthening in the balance of payments in Malaysia has been the substantial improvement in the capital account which itself is a function of the RM/US\$ interest rate differential (Chart 5). Like Taiwan in 1985, Malaysia has an undervalued RM/US\$ exchange rate on a PPP basis using either the consumer price or wholesale price indices anchored at 1972. BNM's aim to maintain this for as long as is feasible coupled with an anti-inflation outlook motivates it to continue with the sterilised intervention policy. As was the case in Taiwan (in the initial stage (A)) credit demand in Malaysia is relatively weak and interest rates are on a declining trend. Provided that there is no significant rise in US interest rates -- so that the net capital inflows remain intact -- there will come a point, perhaps towards mid-1994, when Malaysian interest rates have fallen to a level where many more profitable private lending opportunities become available to commercial banks. Credit growth will then accelerate accordingly. It is around this time (stage B to C in the Taiwanese case) when BNM will be forced to reevaluate its sterilised intervention strategy. Gradually commercial banks will find lending to the private sector more profitable than lending to BNM forcing BNM to offer higher yields to keep the same degree of sterilisation in place. This in turn could undermine the policy to cap the currency. As was the case in Taiwan, BNM will be forced to decide between (i) the cheap unsterilised currency policy and (ii) allowing the RM/US\$ to appreciate and cease its borrowing from the commercial banks. To the extent that it does neither one nor the other at present serves to cloud BNM's aim: higher domestic inflation with a fairly stable undervalued currency or, lower inflation with currency appreciation.

Given that BNM has traditionally been wary of inflationary policies, the first course of action is unlikely. In the longer term, that is in 9-12 months time the second course of action is more likely. However, in the interim period a continuation of the ongoing sterilised intervention policy is to be expected. This is the third (non-option) policy previously set out in the Taiwanese case. Malaysian general elections are expected sometime around mid to late 1994 so it seems probable that BNM may have to conform to the political pressures before then and keep the exchange rate reasonably stable around RM/US\$2.60-2.65 after

letting it appreciate slightly from its current downspike of RM/US\$2.73 (see Addendum below). In addition this sterilisation policy will only become unsustainable when the demand for credit picks up substantially initially causing interest rates to firm. When this point is reached and BNM lets the RM/US\$ appreciate private sector loan growth will be given added impetus as BNM stops borrowing from the commercial banks (sterilising).

Not only will BNM have to drop its current sterilised intervention policy later on in 1994, but it may also have to tighten monetary policy too, if CPI inflation is to be kept under 4-5%. This is because BNM did not succeed in bringing down its real M3 growth rate to that consistent with a lower inflation rate during the 1990-91 monetary tightening (see AMM Vol. 17 No. 1). Moreover, any prospective monetary tightening would only be feasible after the RM/US\$ has been allowed to appreciate so that it reflected the domestic-US interest rate differential more closely.

SUMMARY AND CONCLUSIONS: The outlook for Malaysian monetary policy through 1994 is one where BNM will continue with its sterilised intervention keeping the RM/US\$ rate around 2.60-2.65 after the rate recovers from its current downspike. Given the recent fragility in the domestic demand for credit and given that the net capital inflows will be maintained as dictated by the RM/US\$ interest rate differential, domestic interest rates will continue to decline gently perhaps by 0.5% over the next half a year. Once bank credit growth has picked up substantially, BNM will likely allow the RM/US\$ rate to appreciate as they find the sterilised intervention an increasingly difficult policy to pursue. Moreover there will also have to be a period of monetary tightening because the 18% nominal M3 growth currently in evidence will by then have fed through to stronger domestic demand and higher inflation in late 1994. In addition the prospective expansion in domestic demand will cause the balance of trade surplus to deteriorate and the current account deficit to widen over 1994. This would be another factor prompting BNM to slow down the current decline in domestic interest rates, leading to a reversal in their downward trend later in 1994.

ADDENDUM

Since this article was written BNM has raised the statutory reserve ratio by 1% to 9.5% raising the domestic cost of funds for banks. Most recently BNM has supplemented its sterilisation operations with two capital controls. The first is a ceiling on selected commercial banks net foreign liabilities -- after allowing for foreign funds for trade and investment. The second involves enlarging banks eligible liabilities -- against which banks hold 9.5% as statutory reserves and 17.5% as liquidity assets -- to include foreign currency deposits.

The second control has introduced a large one-off increase in bank funding costs and reduced one incentive to fund domestic lending from external sources causing there to be an initial sharp drop in the RM/US\$ rate to around 2.73. However this depreciated exchange rate will be short lived as the cause of the net capital inflows is still unchanged. Indeed when the domestic banks see that international demand for RM deposits is still as strong as before at the current exchange rate and RM/US\$ interest rate differential they will have an incentive to evade these controls as they seek to maximise their RM asset exposure with respect to that in US\$.

REGIONAL SURVEY

TOP-DOWN MODELS OF STOCKMARKET EARNINGS GROWTH

An economic recovery of varying degrees has been underway in the East Asian economies over the past 12 months. This has given rise to a general expectation that stockmarket earnings growth will accelerate in the region through 1994. This article presents econometric models of earnings growth for Japan, Singapore, Malaysia and Thailand. Each model predicts an upturn in earnings growth (or a slower decline in the case of Japan), given various scenarios for the explanatory variables. As earnings data is not readily available a quarterly series was calculated using the stockmarket price index and PE ratios from Datastream. The structural changes in the Hong Kong economy, as the manufacturing base relocates to China, and manifold distortions in the data made attempts to model earnings growth in Hong Kong unsuccessful.

All of the models were derived from the same basic equation which contained: broad money (M2 or M3) growth, interest rates (or yield curve), exchange rates, GDP and exports growth. The final model for each economy turned out to be different from the basic model only in terms of lag structure and combination of variables. However the variables common to all 4 models are: broad money growth (or bank credit growth in Singapore), an effective (trade weighted) exchange rate and an indicator of the real economy: either exports, GDP or industrial production growth. The Japanese model, the only one to include an interest rate variable, was significantly improved by including a yield curve (defined to be 10 year Government bond yield - 3 month Gensaki rate). The limited availability of data for Thailand and Malaysia constrained both models to a relatively short time span of six years. In Thailand a problem of data availability meant that GDP and the exchange rate were represented in real terms and the model was adjusted to incorporate inflation by the addition of a CPI term. All explanatory variables are year-on-year growth, except the Japanese yield curve and Singapore's nominal effective exchange rate. Each model explains at least 70% of the variation in the earnings variable and captures most of the significant turning points. The final models are:

Malaysia: Earnings = $(-0.23) + (0.8) M3 + (1.3) M3 [t-1] - (1.5) NEER [t-4] + (0.5) EXPORT [t-6]$

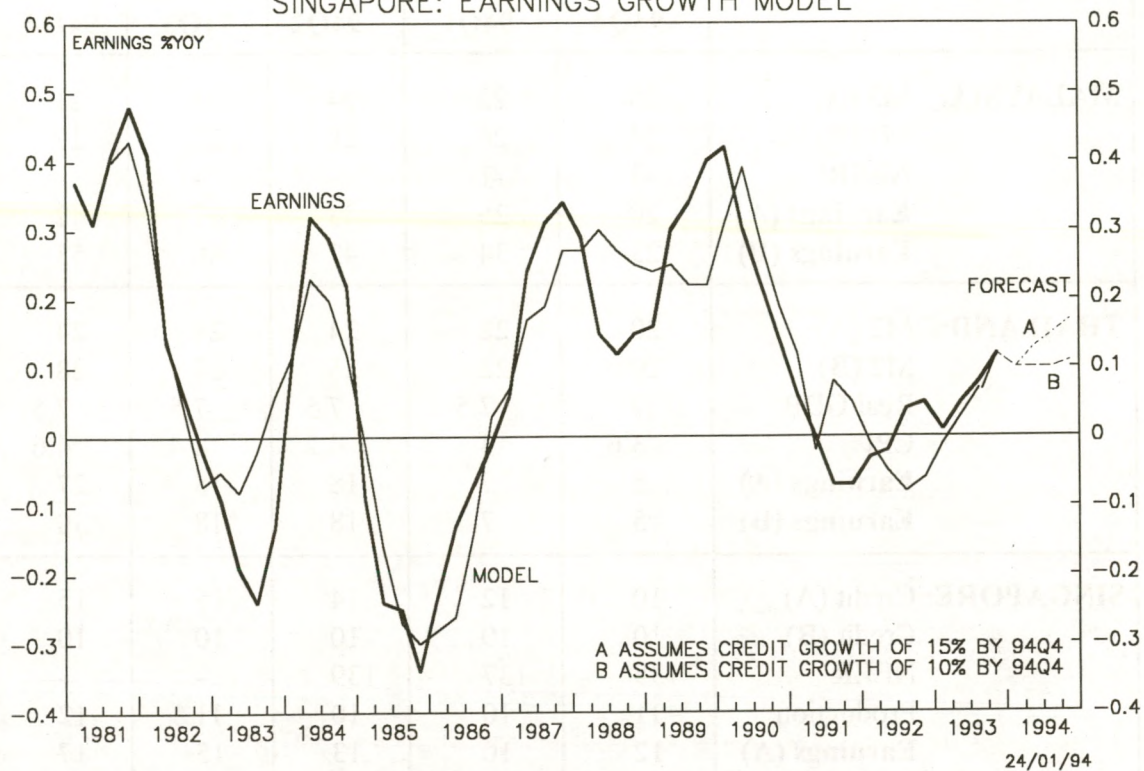
Thailand: Earnings = $(-0.8) + (3.6) M2 [t-2] + (4.9) GDP - (3.3) CPI - (3.7) REER [t-4]$

Singapore: Earnings = $(0.7) + (1.2) CREDIT [t-1] - (0.007) NEER [t-2] + (0.7) PROD + (1.0) PROD [t-2]$

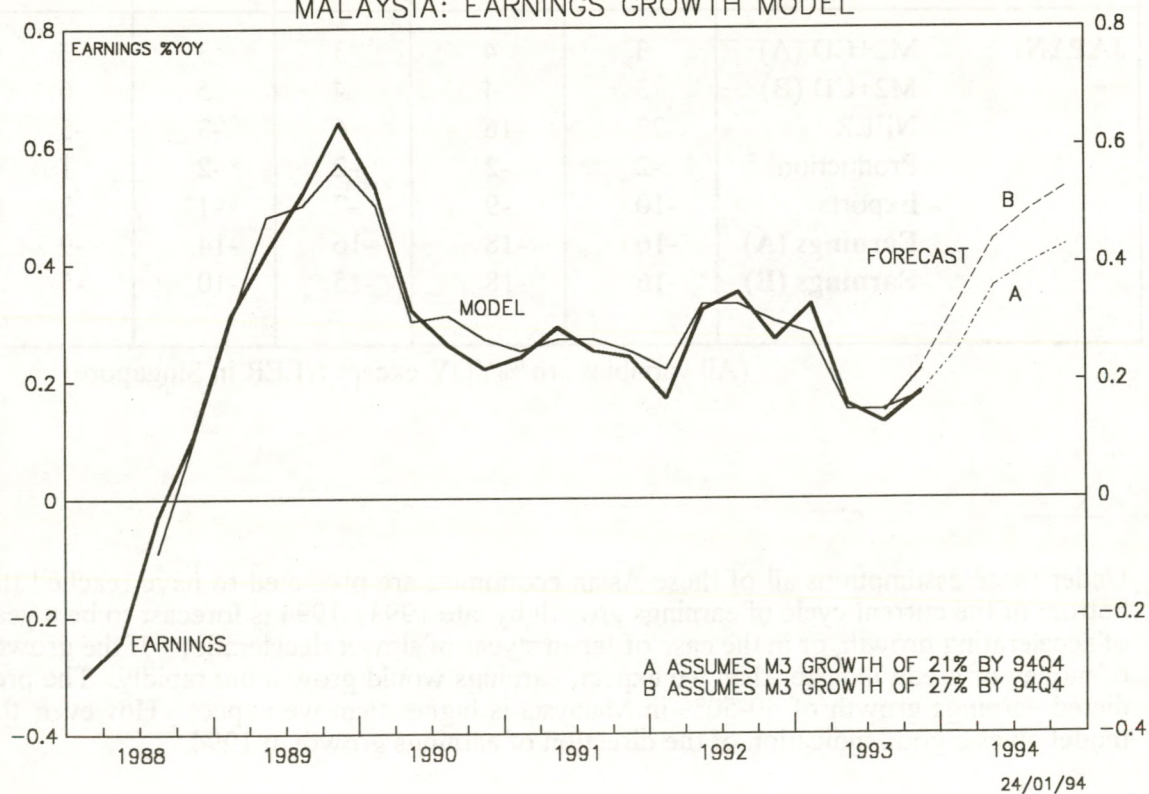
Japan: Earnings = $(-0.1) + (0.3) EXPORT [t-1] + (1.7) M2 - (0.2) NEER [t-1] + (1.0) PROD [t-2] + (0.009) YIELD [t-6]$

Forecasts of earnings growth from these models were obtained using G.T. 1994 estimates of the explanatory variables. Several scenarios were constructed which were based on different estimates for some of the explanatory variables and earnings growth in 1994 was found to be most sensitive to changes in monetary and credit growth. Forecast A is generated using our projections of the growth in the explanatory variables while forecast B contains predictions of faster (or slower in the case of Singapore) money and credit growth, giving an indication of the impact of this on earnings growth. However the demand for credit in Asia is expected to expand through 1994 as the low interest rate environment and wealth effects feed through to stronger domestic demand.

SINGAPORE: EARNINGS GROWTH MODEL



MALAYSIA: EARNINGS GROWTH MODEL

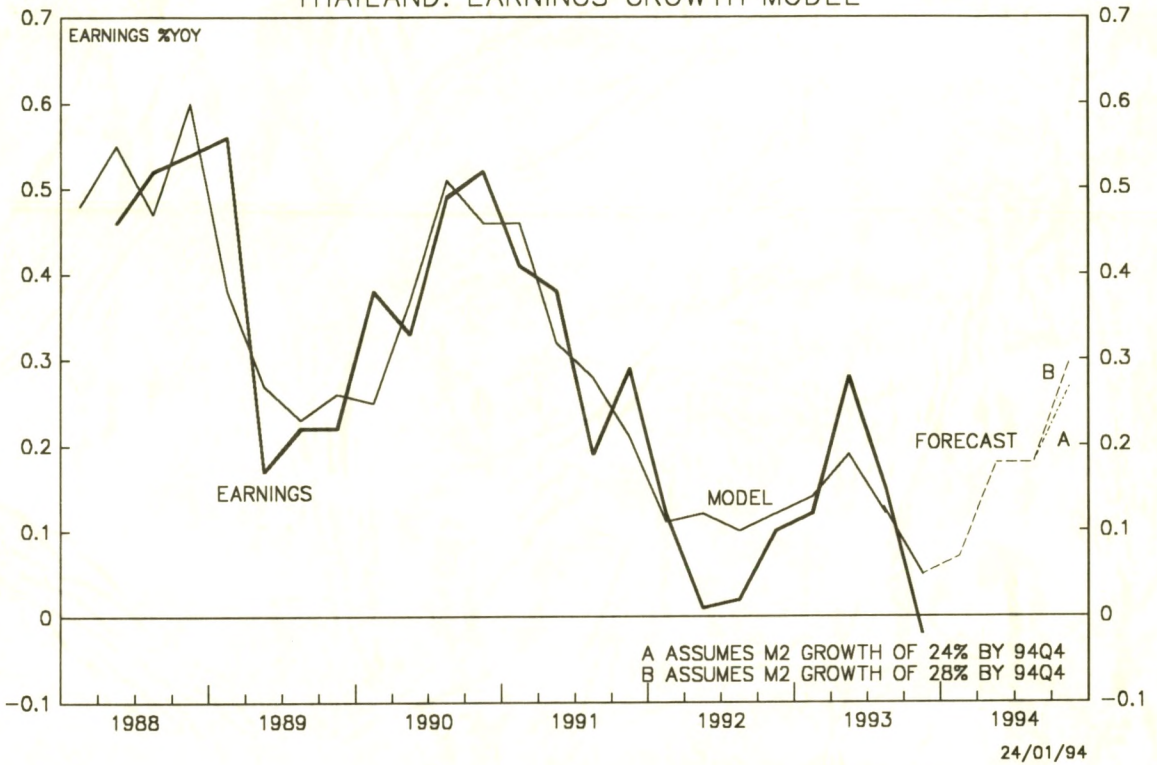


	93Q4	94Q1	94Q2	94Q3	94Q4
MALAYSIA: M3 (A)	20	22	24	25	21
M3 (B)	24	26	28	29	27
NEER	-3	-1	-	-	-
Earnings (A)	20	25	33	37	42
Earnings (B)	23	34	42	46	53
THAILAND: M2 (A)	20	22	24	24	24
M2 (B)	20	22	25	27	28
Real GDP	7	7.5	7.5	7.5	7.5
CPI	3.6	4	4.2	4.4	4.6
Earnings (A)	5	7	18	18	27
Earnings (B)	5	7	18	18	30
SINGAPORE: Credit (A)	10	12	14	15	15
Credit (B)	10	10	10	10	10
NEER	135	137	139	-	-
Production	11	10	10	11	12
Earnings (A)	12	10	13	15	17
Earnings (B)	12	10	10	10	11
JAPAN: M2+CD (A)	3	4	3	3	3
M2+CD (B)	3	4	4	5	6
NEER	22	16	6	-3	-5
Production	-2	-2	-2	-2	1
Exports	-10	-9	-7	-1	3
Earnings (A)	-16	-18	-16	-14	-9
Earnings (B)	-16	-18	-15	-10	-5

(All variables are %YOY except NEER in Singapore)

Under these assumptions all of these Asian economies are predicted to have reached the bottom of the current cycle of earnings growth by late 1993. 1994 is forecast to be a year of accelerating growth, or in the case of Japan a year of slower deceleration. If the growth of money or credit is faster than we expect, earnings would grow more rapidly. The predicted earnings growth of 40-50% in Malaysia is higher than we expect. However, the model gives a good indication of the direction of earnings growth in 1994.

THAILAND: EARNINGS GROWTH MODEL



JAPAN: EARNINGS GROWTH MODEL

